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REHABILITATION TAX CREDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

JUNE 6, 1989

Serial 101-29

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REHABILITATION TAX CREDIT

TUESDAY, JUNE 6, 1989

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to notice, at 11:15 a.m., in room B-318, Rayburn House Office Building, Hon. Barbara B. Kennelly presiding.

[The press releases announcing the hearing follow:]

FOR IMMEDIATE RELEASE
TUESDAY, MAY 2, 1989

PRESS RELEASE #3
SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON THE REHABILITATION TAX CREDIT

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a public hearing on the rehabilitation tax credit on Tuesday, June 6, 1989, beginning at 10:00 a.m., in B-318 Rayburn House Office Building.

The Subcommittee will receive testimony from the Administration and public witnesses. Interested parties who are not able to appear are requested to submit written statements for the hearing record.

The Subcommittee will review the operation and effectiveness of the rehabilitation tax credit. The Tax Reform Act of 1986 restructured and decreased the rehabilitation tax credit in order to conform it to other changes in the Act. Sufficient data is now available from the Department of the Interior to allow the Subcommittee to study the impact of these changes on the use and availability of the credit. Included in the Subcommittee's review will be an examination of the interaction of other provisions of the 1986 Act, including the passive loss rules, with the rehabilitation tax credit.

In deciding to review the rehabilitation tax credit, Congressman Rangel stated: "Since the enactment of the 1986 Tax Reform Act, data indicates that the number of historic preservation projects has decreased. It is important that we review this data in order to determine whether the operation of the credit should be modified."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Friday, May 26, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Tuesday, June 20, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * CHANGE OF DATE AND TIME * * *

FOR IMMEDIATE RELEASE
WEDNESDAY, MAY 24, 1989

PRESS RELEASE #2 AND #3-REVISED
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN DATE AND TIME OF THE MAY 30, 1989, SUBCOMMITTEE HEARING ON THE TARGETED JOBS TAX CREDIT, AND A CHANGE IN TIME OF THE JUNE 6, 1989, SUBCOMMITTEE HEARING ON THE REHABILITATION TAX CREDIT

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee's hearing on the targeted jobs tax credit, originally scheduled for 2:00 p.m., Tuesday, May 30, 1989, has been rescheduled for 9:30 a.m., Tuesday, June 6, 1989, in Room B-318 Rayburn House Office Building.

The Subcommittee's hearing on the rehabilitation tax credit, originally scheduled for 10:00 a.m., Tuesday, June 6, has been rescheduled to follow immediately after the conclusion of the Subcommittee hearing on the targeted jobs tax credit in Room B-318 Rayburn House Office Building.

All other details for the hearings remain the same. (See Press Release #2, dated May 1, 1989, and Press Release #3, dated May 2, 1989.)

* * * * *

Mrs. KENNELLY. We want to move right along. As you all know, the day is rather different, and an exciting day in some ways, and certainly a historical day. But we are running late. So I think if we just move along now and begin this very important rehabilitation tax credit hearing, we will be able to finish at a good time.

Mr. James Ridenour will be our first witness; Director of the National Park Service.

Mr. Ridenour, welcome to our committee; and once again, congratulations on your new position as Director of the National Park Service. I look forward to your testimony, sir; and know that all your testimony will be placed on the record.

STATEMENT OF JAMES M. RIDENOUR, DIRECTOR, NATIONAL PARK SERVICE, U.S. DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY JERRY ROGERS, ASSOCIATE DIRECTOR FOR CULTURAL RESOURCES

Mr. RIDENOUR. Thank you very much. I have with me Jerry Rogers, who is our Associate Director for Cultural Resources, in case we need to call on the expert.

I guess what I will do is summarize my testimony and come at it from the angle that being a former State historic preservation officer from Indiana, which was an additional duty that I had as the director of natural resources, I am just here to bubble about the program a little bit.

The town of Indianapolis, I lived in 20 years ago; went away; spent my time in the Service; and when I left Indianapolis, it properly deserved the title of Indian-No-Place; though when I came back and saw the activity that had taken place and is taking place, has taken place in Indianapolis because of the historic preservation program, it is just a town revitalized. And it is absolutely amazing to see the differences that have taken place.

I just returned from giving a speech for the dedication of the Fordyce Bathhouse in Hot Springs, AR. And again, I had seen that town a few years ago and thought that it was on its way out. But now, happily, it is on its way back; and I think we can tie that directly into the tax credit program.

The history of the tremendous growth after passage of the Economic Recovery Tax Act of 1981, which replaced the early incentive with a 25-percent investment tax credit for historic rehabilitations, and lesser credits for rehabilitations of older, but nonhistoric buildings—well, within 2 years, the number of projects doubled when that program got underway—and the amount of investment tripled.

By 1984, the National Park Service tax incentive program had stabilized at about 3,000 projects and $2 billion investment per year; that is private investment. Since 1976, over 100,000 housing units, including 17,000 low- and moderate-income units have been rehabilitated under historic preservation tax incentive programs. Fifty-one percent were newly created housing units by adaption from other uses or from rehabilitation of abandoned or unused structures.

Now, our situation is the rate has dropped to about one-third of that previous rate; and in fact, I have some figures here for your

own State. Mrs. Kennelly, in your State, the drop of applications between 1985 and 1988 has been about 76 percent. And we also equate that to investment, a drop of about 76 percent.

When the program was running at its best in 1982 to 1985, Connecticut ranked 11th in the number of rehabilitation projects and 12th in the amount of investment. The estimated number of jobs created was 8,610; and the housing units created—2,318.

Texas ranked 8th in the amount of investment and 15th in the number of rehabilitation projects; estimated number of jobs created, 16,000. We had, from 1986 to 1988, $57 million in investment. Now, I know we get into some concerns about—and there are legitimate arguments about how much this program costs—but I do know this, when you put people to work, when you put people in programs where they are rehabilitating neighborhoods, they are upgrading housing, you certainly see the return on investment at the State and local level.

I have a feeling, if the numbers were crunched properly, when you talk about the income levels of the people who are working in the program, you would find that that return is significant as well. Unfortunately, I have not seen any figures that give me those numbers right off the top of my head.

But I believe that when you put that many people to work—plasterers, carpenters, plumbers and all the people that get involved in the rehabilitation program—that you would find a return on investment that would be one that would be enviable.

From October 1988 to April 1989—that is just this past October 1988 to 1989—only 514 projects, representing about $391 million investment, have been approved by the National Park Service. So we are dropping off significantly. We are off about, almost two-thirds last year; and this year, it looks like it will be even more.

I think one of the things that people argue about is what kind of projects are allowed in the investment program, and what kind of projects are not. There are sometimes arguments about that. Certain types of renovation projects cited by critics of Federal tax incentives would not and have not been approved by the National Park Service.

Projects involving new construction behind only the facade of a historic building, such as the Army Navy Club the Red Lion Row, the Evening Star Building and the Homer Building, and the Bond Building, would not have been allowed, or have not been allowed, under this program.

Projects involving substantial rooftop additions that change the size and scale of the historic building, such as the Southern Building and the Jennifer Building, not allowed. Projects involving only the shell of a building while gutting the interior, such as the warehouse in Georgetown Park now occupied by CONVAN's again, are not allowed.

I would like to kind of summarize and close on a positive note on some that have been allowed that, I think, all of us will be familiar with. Several notable Washington, DC projects that retain and preserve distinctive features and spaces on the interior wall being upgraded to meet current needs and have qualified for certification under the Secretary's standards: these include the Willard Hotel; Union Station, which now contains theaters, shops, restaurants

and, once again, an efficient Amtrak station, and literally hundreds of rowhouses in the Capitol Hill, Dupont Circle and Georgetown historic districts.

I know this from personal experience in Indiana, and not just Indianapolis, but cities all around our State; we saw significant decline in the deterioration of our downtowns. We saw people at work. We saw people from all trades earning an income on which they obviously paid income taxes. We saw neighborhoods stabilized. We saw that decline that was rapidly decaying our cities slow significantly; and we viewed it, as a State, as a very positive program.

Speaking as a former State official, I can just say that it was one of the most positive programs we have ever had in working in the relationship between State and Federal Government. I strongly supported the program as a State official, and I strongly support the program now in my new role—a month and one-half—as a Federal official.

That concludes my remarks.

[The statement of James M. Ridenour follows:]

STATEMENT OF JAMES M. RIDENOUR, DIRECTOR, NATIONAL PARK SERVICE, DEPARTMENT OF THE INTERIOR BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, HOUSE COMMITTEE ON WAYS AND MEANS, CONCERNING THE REHABILITATION TAX CREDIT.

June 6, 1989

Mr. Chairman, thank you for the opportunity to come before you this morning to describe the experience of the National Park Service in administering the historic preservation tax incentives program and to tell you that, because of my former capacity as State Historic Preservation Officer for the State of Indiana, I am personally familiar with the positive impact of the Federal historic preservation tax incentives on States and communities throughout this Nation.

In the late 1960s it was common to see block after block of older buildings in American cities standing empty. These buildings were not merely historic resources in trouble and not just economically unproductive--they were costly focal points of accidents, injuries, fires, crime, and civic degradation. In 1973, the President of the United States acknowledged the importance of preserving our historic buildings rather than continuing the wholesale demolition that had occurred in the 1960s as part of urban relocation programs. He called specifically for changes in the tax code that would, and I quote, "encourage rehabilitation of older buildings." This policy directive ultimately resulted in enactment of the Tax Reform Act of 1976 which established the first Federal tax incentives to encourage historic rehabilitation. The history of these incentives is of gradually increasing use in the late 1970s followed by tremendous growth after passage of the Economic Recovery Tax Act of 1981 which replaced the early incentives with a 25 percent investment tax credit for historic rehabilitations and lesser credits for rehabilitations of older but nonhistoric buildings. Within 2 years the number of projects doubled and the amount of investment tripled. By 1984, the National Park Service tax incentive program had reached about 3,000 projects and $2 billion per year in private investment.

The historic preservation tax incentives have been a successful urban revitalization tool. Between June 1976 and April 1989, over 20,000 historic building rehabilitations have been approved by the National Park Service to qualify for tax credits. At a Federal cost of some forgone tax revenues, these projects have generated a private investment of $13 billion and almost all have been done since 1981. Rehabilitated historic buildings that often were a serious drain on the private economy and on Federal, State and local treasuries have brought renewed life and diversity to business and residential districts, resulted in jobs in connection with these projects that create income and generate State and local taxes, increased local and State revenues, and provided new, high-quality housing for families of all income levels.

Since 1976, over 100,000 housing units, including 17,000 low and moderate income units, have been rehabilitated under the historic preservation tax incentives program. Fifty-one percent of these units were newly created through adaption from other uses, or more frequently, from abandoned or unused structures. Successful projects in Indianapolis, New York; Pittsburgh, Camden, St. Louis, Savannah, and Albany, NY, show that rehabilitation can occur without displacement.

However, changes to the tax code as a result of the Tax Reform Act of 1986 have reduced the attractiveness of the Federal tax incentives as a means of stimulating private investment in historic rehabilitation projects. National Park Service data compiled since the beginning of the certified rehabilitation program reflect a dramatic drop in the number of projects being undertaken. In Fiscal Year 1988, the first full cycle since passage of the Tax Reform Act of 1986, the number of projects approved fell to 1,092, which is about one-third the pre-Tax Reform Act level of about 3,000 projects per year. Investment in historic rehabilitations in Fiscal Year 1988 dropped to $866 million which is about one-third of the pre-Tax Reform Act level of the peak of $2.4 billion in 1985. However, despite the drop in the number of historic rehabilitation projects, housing continues to be the most popular use for rehabilitated buildings, with about half of all projects in Fiscal Year 1988 involving rental-residential use. Preliminary figures from October 1988 through April 1989 indicate that 514 projects have been approved so far this fiscal year, which would mean that the level of activity continues to drop, although the rate of decline has decelerated.

Before I was named Director of the National Park Service, I served as the State Historic Preservation Officer for the State of Indiana and one of my responsibilities then as now was the administration of the historic rehabilitation tax incentives certification program. The historic rehabilitation project in Indiana of which I am most proud is the rehabilitation of Union Station in Indianapolis. The Station, which was owned by the City, was seriously deteriorated and threatened with demolition. As a result of a a joint project between the City and a local developer, Union Station was so successfully rehabilitated that the State of Indiana conveyed its annual historic preservation award to the Station in 1987. This rehabilitation is the largest project in Indiana to date. The project generated nearly $26 million in private investment and contains 570,000 square feet of space now occupied by an AMTRAK/Trailways Bus Depot, a festival market place, a hotel, and retail, commercial and office space.

During the time I was State Historic Preservation Officer, we recognized that the availability of the Federal tax incentives was an important tool in the revitalization of a number of Indiana cities, including Indianapolis, South Bend, Evansville and Lafayette. During the peak years of historic rehabilitation activity in the mid-1980s, part of the renaissance activity in Indianapolis was a move to bring decent affordable housing back to downtown and a number of older apartment buildings were renovated using the historic rehabilitation tax credits. Unfortunately, this trend has slowed since 1986.

Finally, I would like to explain briefly how projects receive approval for Federal tax credits. All rehabilitations seeking the historic preservation tax credit must receive indepth review both at the State level by the State Historic Preservation Office and at the Federal level by the National Park Service before certifications are granted. To be certified, rehabilitation projects must be consistent with the historic character of the building and must meet all 10 of the Secretary of the Interior's Standards for Rehabilitation which are contained in the Code of Federal Regulations. The Secretary's Standards for Rehabilitation require retention of the entire historic building not simply the facade and distinguishing historic features on the exterior and interior of the building. While 20,000 projects representing a private investment of $13 billion have received approval from the National Park Service for Federal tax credits, this is only a small fraction of the total number of older and historic buildings that have been renovated during the past 12 years.

We want the Congress to understand that we believe the program is run with strength and integrity. The vast majority of applicants receive the certification they seek, but only after working with our National Park Service historic preservation experts and our partners in the State programs--the projects are good ones. Projects that do not meet the Standards are denied. Owners may appeal to the National Park Service Chief Appeals Officer; this individual is a highly qualified and respected professional and his decisions are final. Throughout the whole program there has not been a single instance of interference in the professional application of the Standards for Rehabilitation. Let us be clear, projects that retain only facades with new construction behind do not qualify. Projects that include substantial rooftop additions that change the building's size and scale or obscure distinguishing features such as decorative cornices do not qualify. Projects that retain only the shell of the building while gutting the interior do not qualify. They are not rehabilitation projects.

Finally, I would like to close on a positive note by mentioning several notable Washington, D. C., projects that retain and preserve distinctive features and spaces on the interior while being upgraded to meet current needs and have qualified for certification under the Secretary's Standards. These include the Willard Hotel, Union Station, which now contains theatres, shops, restaurants, and once again an efficient AMTRAK station, and literally hundreds of rowhouses in the Capitol Hill, Dupont Circle, and Georgetown historic districts.

Mrs. KENNELLY. Thank you, Mr. Ridenour. I read your statement in its entirety; and you emphasize in it—as you have in your testimony just now—that you see the numbers of projects dropping; in fact, rather dramatic drops in numbers, such as my own particular State, and States across the Nation.

Do you think the number of projects started will continue to drop, or do you think we have bottomed-out?

Mr. RIDENOUR. I think it will probably continue to drop. I think that—I really would wonder if, back when the tax laws were changed in 1986, if when it was dropped from 25 percent credit to the 20 percent credit—I think that we would probably still have seen this activity at a very high level. But it was a change in that other portion of the tax law which seems to be the major problem.

I am not sure Congress really intended at that time for that to happen.

Mrs. KENNELLY. Well, do you agree with me then, since you see this dramatic drop off during the past 2 years, and you can see that it is going to continue to drop off, that we should fix this so that we can continue, as you said at the beginning of your statement, preserving our history, as well as providing some housing?

Are you with me in believing that something should be done to fix this situation?

Mr. RIDENOUR. Yes, I am.

Mrs. KENNELLY. I appreciate your talking about the strict standards, sir. And, in fact, I understand you have even litigated—or the National Park Service has litigated—when these standards have not been complied with. And you did name some of the same projects like Red Lion Row and the Army Navy Building that I bring up to show that this is a very particular, strictly regulated program where you must comply with the standards that that National Park Service sets forth.

And I am glad you have that in your written testimony; and you mentioned it too. But along the same lines, let us say local building codes require a developer to do something that would significantly diminish the historic character of the building. Is it my understanding the developer would not be certified for the credit if, in fact, a developer—really eliminated the historical character of a building?

Mr. RIDENOUR. Come on up, Jerry.

I would say my experience as a State official——

Mrs. KENNELLY. I should have asked him to sit up here.

Mr. RIDENOUR. Yes.

I think my experience as a State official is that those standards were very strict, and are very strict, because I got hammered constantly as a State official to get something approved.

Mrs. KENNELLY. If the historical value was significantly diminished in the process of the new development, or in the presentation of what was proposed for the new development—would it in fact not get the credit?

Mr. ROGERS. You are absolutely correct, Madam Chairman. The tax incentive program, as we see it, was enacted to encourage the rehabilitation of historic properties according to the character of the historic property.

There are thousands of other worthy social goals like those that are supported by building codes. And we work very hard—we, and our partners in the States—to cooperate with the people who administer those codes, and to try to make them fit. And almost always, we are able to. But ultimately, if you have to destroy the historic character of the building to rehabilitate it, you do not get the credit.

Mrs. KENNELLY. So I think what we are saying here is, unlike most tax provisions, this is a tightly controlled program with very strict standards. Is that what you are saying to me in your testimony today?

Mr. RIDENOUR. Yes.

Mrs. KENNELLY. Thank you. Let us get to the other subject. Do you know of any reason other than the passive activity rules that could have caused such a dramatic drop-off—such as in Connecticut's case, a 76 percent drop-off—in historical rehabilitation activity during the past couple of years?

Mr. ROGERS. We heard the testimony of the Treasury Department this morning that hypothesized other reasons. Certainly we are in no position to contradict that. The only thing I would say is that when we have asked the users of the program, they have told us that the passive activity rules and the inability to get financing support have been the principal restraint on new projects.

Mrs. KENNELLY. Well, I would just like to have the record show that the National Parks Service's fiscal year 1988 analysis of tax incentives for rehabilitating historic buildings attributes the fall off to the passive loss and credit provisions of the 1986 act. And I will put that on the record.

Mr. ROGERS. That is correct.

Mrs. KENNELLY. Mr. Andrews.

Mr. ANDREWS. Thank you. First, I want to thank the chairlady for recognizing me. I suggest that we would not be here were it not for Barbara Kennelly's work and enthusiastic sponsorship of this provision.

And Mr. Ridenour, I am delighted to meet you and have you before our committee. Congratulations on your appointment.

The Treasury Department testified a little earlier today; and one of the things that was suggested as a potential change was that we should apply a new test to determine whether a building had historic public benefit. I am not sure I quite understand what that means, whether that means it has to be open to the public or not, or maybe in an area where the general public would see it. What are your thoughts about that? Does that make sense with this credit?

Mr. RIDENOUR. Well, I am not sure again what historic public benefit might be; but certainly when you redo a Union Station, and you provide all the facilities and the kind of activities that take place in the Union Station, in addition to all the jobs that took place to do that, I would certainly say that that is a public benefit.

Certainly, it is tied to a historic building. The same would be true for a neighborhood, for example, involved in revitalization. The neighborhood in a historic district is certainly historic; certainly it is a public benefit that has been revitalized.

Mr. ANDREWS. Well, I guess for a Union Station, it would be easy to see that it would qualify. But what I am really curious about is what about buildings that are in the backwaters of a community? They are buried away in an older neighborhood, and yet are important historically.

Mr. RIDENOUR. Well, I might just say one thing about my own personal experience. So many times I have seen one or two homes, for example, where—well, OK, I will just talk about homes—where someone is in the position to fix-up, clean-up, paint-up, do the things to put it back into its prior condition—where that sparked interest in the neighborhood to do similar things.

All of a sudden, rather than that neighborhood sliding further down and finally just becoming a mess, everyone began to take pride and began to do those things, whether they were on the historic register or not, and salvaged the whole neighborhood. I saw that many times in our activities in Indiana.

Mr. ANDREWS. Is it not true that most of the jobs and most of the economic activity does not occur in big, large, full-scale developments like Union Station, but rather in smaller individual storefront type community buildings?

Mr. RIDENOUR. I think that is accurate. Certainly that was our experience in Indiana.

Mr. ANDREWS. Well, thank you very much for your testimony today.

Thank you.

Mrs. KENNELLY. Thank you. I came into this like you did Mr. Ridenour, back home. And I can always remember the arrogance of New England. Before I came to Congress and traveled a little more than I did when I was in Connecticut, I thought we were just so marvelous and wonderful in historic rehabilitation.

Then I went to places like Texas, Sacramento, where they were doing exactly what we were doing with the historic rehabilitation. And as usual, we up in New England think we started it all; but it truly exists across this country. And I thank you for your interest, because preservation really makes our country special and will keep us special.

Mr. RIDENOUR. Well, you have done an outstanding job in New England. And I have to admit, when I first got into this business and was in the process of taking my son off to school in New England, I thought, do we have anything in Indiana that is as historic as you have in New England? But I was absolutely amazed at the pride we took in our State once we really got rolling in the program.

Mrs. KENNELLY. Once people realize what can be done, it is amazing what they do.

Mr. RIDENOUR. Yes.

Mrs. KENNELLY. That is why we are here.

Mr. RIDENOUR. That is right. Well, thank you.

Mrs. KENNELLY. Thank you, sir. And it was very nice to see you again.

Mr. RIDENOUR. Thank you very much for having me.

Mrs. KENNELLY. Our next panel will be the National Trust for Historic Preservation, J. Jackson Walter, president; National Conference of State Historic Preservation Officers, Orin Lehman, New

York State preservation officer, commissioner of New York State Department of Parks, Recreation and Historic Preservation; Preservation Action: Nellie Longsworth, president.

I understand that Mr. Lehman has a plane problem which we all can relate to and so, sir, why don't you begin with your testimony?

STATEMENT OF ORIN LEHMAN, STATE HISTORIC PRESERVATION OFFICER, AND COMMISSIONER, NEW YORK STATE OFFICE OF PARKS, RECREATION AND HISTORIC PRESERVATION, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE HISTORIC PRESERVATION OFFICERS

Mr. LEHMAN. Thank you very much, Madam Chairman, Congresswoman Kennelly, for having us here. I appreciate very much being here.

This is a wonderful program and I am delighted to have a chance to speak on this panel. It is a pleasure for me to appear before you today. My name is Orin Lehman. I am commissioner of the New York State Office of Parks, Recreation and Historic Preservation. I also serve as the State historic preservation officer. It is in that capacity that I appear before you today.

Through the creation of historic preservation tax incentives, Congress assured the survival and eventual reuse of literally thousands of our Nation's most important cultural resources. Some, like the Woolworth Building and the Chrysler Building, were national historic landmarks well known to most Americans. But I think most of them were buildings regarded as white elephants for which there was no future. They were buildings on main streets, in the neighborhoods. They were commercial buildings, mill buildings, abandoned houses, urban and rural and located in every part of our State.

Everyone expected that these incentives would work to make rehabilitation feasible for many historic structures, and they really did. Fully 75 percent of the buildings completed using Federal tax incentives would not have survived without them. A welcome, but unexpected result of the tax incentives was the tremendous awakening of interest in historic buildings, first among developers, I guess, and probably entrepreneurs and bankers, and then spreading to the general public. Through the investment tax credits, preservation became one of the most powerful engines driving economic development and revitalization in the State and throughout the country.

New York State has always made extensive use of the investment tax credits for certified rehabilitation because we have a very high density of historic resources in need of rehabilitation. And because our office has aggressively promoted the use of the credits in combination with low income housing credits.

A few basic statistics will give you an idea of how important the program has been in New York.

Since 1976, the program has caused nearly $1.4 billion to be invested in New York's historic buildings. New York ranked first in the use of the program in 1988, and New York City, Albany and Rochester have consistently ranked among the top 50 cities using

the program. Over 54,000 jobs and 7,200 housing units have been created by the program.

Increased State income taxes, sales taxes and property taxes are less visible but important benefits at all levels of government.

The Tax Reform Act of 1986 attempted to close a number of tax loopholes with a series of complex rules. The primary programs affected by these limitations were rehabilitation tax credit and low income housing credit. These programs were established to encourage investment in areas that Congress felt were desirable because of their high cost, high risk and limited return, were considered too uneconomic to attract private capital on their own.

The result of these changes on both preservation projects and housing projects has been devastating to our State's program. New applications have dropped 71 percent since 1985. The dollar value of projects declined from $264 to $125 million between 1987 and 1988. Only 42 proposals were received in 1988 down from a high of 523. And even this small number was enough to rank New York as the No. 1 user of the program in 1988.

These grim figures tell only part of the story. A recent analysis of the new law suggests that it is best suited to very small and very large projects, while midrange projects have become difficult to finance.

New York's experience seems to bear that out. In the past three years, we have seen the average size of a project rise from $600,000 to $1.4 million. The impact of tax reform has thus hit hardest on those midsized projects which are usually the most marginal from an economic standpoint. These are the projects which are also often found in smaller towns and cities having access to few other sources of financing.

For New York State, the class of projects hardest hit was housing. Fully 80 percent of the project using the tax credits between fiscal years 1986 and 1988 were housing projects. More than 7,200 housing units were created since 1982, using the tax credits for certified rehabilitation. But we have dropped from a high of around 1,200 units to only 134 units last year.

The record confirms that New York has always taken a very active role in both housing and historic preservation. In both areas, the State has not been content to rely on Federal programs alone to solve our problems. And in 1986 the voters passed the Environmental Quality Bond Act allocating about $50 million for historic preservation projects, the first such money since the Federal grants and aid were pretty much eliminated in 1981.

One proposal currently before Congress is the Community Revitalization Tax Act, H.R. 795. We believe that this proposed legislation would solve the problems faced by those of us attempting to encourage private investment in historic buildings and in low-income housing.

Adoption of the legislation would simplify the operation of the passive activity provisions, increase the pool of eligible investors, and provide a uniform credit limitation while, at the same time, preserving both the alternative minimum tax and the passive loss concept.

Clearly, the Investment Tax Credits for Historic Preservation provide a stimulus which simply cannot be met through grant pro-

grams or by direct intervention of governmental agencies. They represent the best aspects of the public/private partnership by providing a very low cost incentive both in terms of the cost to the Treasury and in terms of the cost to administer the program. It has channeled significant private investment into historic structures which would not exist today without that investment. It has provided badly needed housing units. It has helped to revitalize entire commercial streets and neighborhoods. It has provided jobs, training, and a wide range of spinoff benefits throughout the State.

As I hope I have illustrated by this brief testimony, the investment tax credits have been a very, very powerful stimulus in New York State. I think it has been a wonderful program. There probably have been some profits made by the private sector, and that's fine. But, really, our built environment and our historic structures have been saved by this program, certainly many of them, not all of them, but certainly many of them. But this program today is faltering badly so I urge you to examine all the alternatives available to make it work again.

Thank you very much.

[The statement of Mr. Lehman follows:]

TESTIMONY OF

ORIN LEHMAN, COMMISSIONER

NEW YORK STATE OFFICE OF PARKS, RECREATION AND HISTORIC PRESERVATION

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES

June 6, 1989

Mr. Chairman and distinguished members of the Committee it is a pleasure for me to appear before you today. My name is Orin Lehman. I am Commissioner of the New York State Office of Parks, Recreation and Historic Preservation. I also serve as State Historic Preservation Officer. It is in that capacity that I appear before you today to describe the very positive impacts of the federal tax credits for certified rehabilitations and the serious problem which that program has encountered as a result of the Tax Reform Act of 1986. My oral testimony today will be brief but I would like to direct your attention to the data and analysis of New York's experience with the Investment Tax Credits contained in my written submission.

Through the creation of historic preservation tax incentives, Congress assured the survival and eventual re-use of literally thousands of our Nation's most important cultural resources. Some, like the Woolworth building were National Historic Landmarks, well known to most Americans. But most were buildings regarded as white elephants for which there was no future. They were buildings on main streets and in neighborhoods, they were commercial buildings, mill buildings, abandoned houses large and small located in every part of the State.

Everyone expected that these incentives would work to make rehabilitation feasible for many historic structures and it did. Fully 75% of the buildings completed using federal tax incentives would not have survived without them, according to a recent National Park Service study. A welcome, but unexpected result of the tax incentives was the tremendous awakening of interest in historic buildings, first among developers and bankers, and then spreading to the general public. Through the investment tax credits, preservation became one of the most powerful engines driving economic development in the state and throughout the country.

Since 1976 more than thirteen billion dollars has been spent on upwards of 20,000 historic buildings. But the changes dictated by the Tax Reform Act of 1986 have slowed that investment dramatically. Across the nation, the number of projects approved in FY 88 was 1092, down 43% from FY 87's 1931 projects (NPS statistics). The number of projects is now holding at about one-third the pre-Tax Reform Act level.

New York State has always used the Investment Tax Credits for Certified Rehabilitation extensively because we have a high density of historic resources in need of rehabilitation and because my office has aggressively promoted the use of the credits in combination with low-income housing credits. From its inception in 1976, the tax credit program has resulted in nearly $1.4 billion dollars of investment in our State's historic buildings. New York State ranked first in the nation in use of the credits during 1988. New York City, Albany and Rochester have consistently ranked among the top 50 cities in the country using the credits to accomplish the rehabilitation of large

numbers of commercial and housing units. For older cities throughout the country, the Investment Tax Credits for Certified Rehabilitation have proved a crucial tool for responsible urban revitalization.

The spin off benefits to the State have also been substantial. Using multipliers computed by the Bureau of Economic Analysis, U.S. Department of Commerce we have been able to estimate that:

* The gross output (impact on NY) of this work totals $4.523 billion

* Over 54,000 jobs have been created in New York

* More than 7200 housing units were created since 1982

In addition, cities and towns have benefited extensively from the program. In New York City, for example, $88,520,000 in rehabilitations were proposed in FY87. We estimate that this would yield $2.65 million in local sales tax, $10 million in state income taxes, and increased property taxes which will significantly improve the ability of localities to provide quality education and city services.

The Tax Reform Act of 1986 attempted to close a number of "tax loopholes." In doing so, a series of complex new rules were designed to limit the ability of individual taxpayers to utilize losses to shelter income from other sources. The primary programs affected by this limitation are the rehabilitation tax credit and the low-income housing credit. These programs were established to encourage investment in areas that Congress felt were desirable but because of their high cost, high risk and limited return, were considered too uneconomic to attract capital on their own.

The current tax law creates a "Catch-22" for investors. To minimize the impact of Tax Reform on these programs, Congress allowed an exemption from the passive activity rules for the equivalent of a $25,000 deduction for a taxpayer's investment in these projects. However, this exemption phases out when the individual's income is over $150,000. To be accredited as an investor by the SEC the individual must have an income of over 200,000.

The alternative to this private placement mechanism is a registered public offering, but the expenses involved are prohibitive for all but the largest and most expensive projects.

The result of these changes on both preservation projects and housing projects has been devastating. Between FY85 and FY88 new applications in New York dropped by 71% (NPS figures). The dollar value of these projects has declined from $264 million in FY87 to $125 million in FY88. Only 42 completed proposals were received in FY88, a trickle compared to previous years when we received as many as 523 projects. Even this small number was enough to rank New York as the number one user of the program in FY88.

These grim figures tell only part of the story. In a recent analysis of the new law, the argument was made that small projects which could be financed by a few investors who meet the income restrictions and very large projects which could use the technique of a public offering to attract a large number of small investors would continue to be used while the middle range projects with a value between $500,000 and $5,000,000 would be very difficult to finance. New York's experience seems to bear that out as, in the last three years we have seen the average size of a project rise from $600,000 to $1.4 million. The impact of Tax Reform has thus hit hardest on those mid-sized projects which are usually the most marginal from an economic standpoint.

These are the projects which are also often found in smaller towns and cities which have access to few other sources of financing.

For New York State, the class of projects hardest hit was housing. Fully 80% of the projects using the tax credits between FY86 and FY88 were housing projects. More than 7240 housing units were created since 1982 using the tax credits for certified rehabilitation. But we have dropped from 1216 units to only 134 units last year (NPS figures).

We believe that New York has always taken a very active role in both housing and historic preservation. In both areas the State has not been content to rely on Federal programs to solve our problems. In 1986 the voters passed the Environmental Quality Bond Act allocating approximately $50 million for historic preservation projects, the first such money since the federal grants-in-aid were eliminated in 1981. Similarly, New York has spent about $150 million to create just under 1500 housing units since 1986, whereas the Tax Credit program created 1821 housing units in the same period with no direct grants.

One proposal currently before Congress is The Community Revitalization Tax Act (H.R.796) We believe that this proposed legislation would solve the problems faced by those of us attempting to encourage private investment in historic buildings and in low-income housing. Three key provisions of this bill would:

* Modify the passive activity rules of Section 469 of the Code to limit their scope to include only losses, not credits.

* Deletes the special exception for rehabilitation and low-income housing that is contained in Section 469.

* Modify the business credit limitation requirements so as to limit the amount allowable for a taxable year to the sum of (a) the first $20,000 of a taxpayer's net tax liability, plus (b) 20% of the taxpayer's net tax liability that exceeds $20,000.

Adoption of the legislation would simplify the operation of the passive activity provisions, increase the pool of eligible investors, and provide a uniform credit limitation while at the same time, preserving both the alternative minimum tax and the passive loss concept.

Clearly the Investment Tax Credits for Historic Preservation provide a stimulus which simply cannot be met through grant programs or by direct intervention of governmental agencies. They represent the best aspects of the public/private partnership by providing a very low cost incentive both in terms of the cost to the Treasury and in terms of the cost to administer the program. As I hope I have shown, it has been a very powerful stimulus in my state. It has channeled significant private investment into historic structures which would probably not be around today without that investment. It has provided badly needed housing units. It has helped to revitalize entire commercial streets and Victorian neighborhoods. And it has provided jobs, training, and a wide range of spin off benefits throughout the state. But this is a program which is faltering badly. I urge you to examine carefully all the alternatives available to make it work again.

Mrs. KENNELLY. Thank you, sir, very much.
Mr. Walter.

STATEMENT OF J. JACKSON WALTER, PRESIDENT, NATIONAL TRUST FOR HISTORIC PRESERVATION

Mr. WALTER. Thank you, Mrs. Kennelly.

For the record, I am Jack Walter, the president of the National Trust for Historic Preservation. I think you have my prepared testimony.

Mrs. KENNELLY. And all your prepared statements will go fully on the record.

Mr. WALTER. Thank you.

I would like to begin by expressing thanks to Mrs. Kennelly, Mr. Schulze and Mr. Andrews and 113 of your House colleagues for your active sponsorship of H.R. 796, the Community Revitalization Tax Act of 1989, and clearly to say up front we urge its very swift adoption.

For more than 20 years, the National Trust has advocated Federal tax incentives for historic preservation. And as you know, Mrs. Kennelly, it turned out that we were right. Enactment of the historic rehabilitation tax credit has to be counted the most successful Government program ever as an incentive to private investment and development in this country's historic areas, and I would like, if I might, to say how pleased I was with Director Ridenour's testimony on behalf of the National Park Service. They are a welcome addition to the combination of forces pressing for a prompt remedy of the problems that we all know beset this tax credit.

My written testimony recites the record and so, too, I am sure will other witnesses. Let me, if I might, point only to one unanticipated benefit which has been the strong partnerships that have been forged between two groups that have not had a tradition of particularly close relationships and certainly never been thought of as allies in the past, and that is this local historic preservation groups and developers.

We now give historic preservation awards, national historic preservation awards to developers, a practice that would have been unheard of in the days before the rehab credits. We are succeeding, all of us, in our goal of attracting developers and investors to do work in historic areas of our communities.

It would be only prudent on the other hand to point out that these credits are only one element, a very powerful one to be sure but, nonetheless, one element of the national historic preservation program.

As you all know, the credits are not useful for nonprofit historic rehabilitation projects carried out, for example, by universities, churches, hospitals. And, furthermore, work in this area does absolutely rely upon the survey work that's done by the State historic preservation officers and others. So, anyone who attempted to say that, well, if we have the rehab credits, then we have a national historic preservation program, is simply missing many, many other elements of a program.

On the other hand, it has been the historic rehab tax credits that have been the key to the National Trust's work on community revitalization all across the country.

The passive activity rules of the 1986 Tax Reform Act in large measure took away the incentive for investing in historic rehabilitation projects, an incentive that we thought that Congress had decided to continue when you resisted all of the proposals to eliminate the rehab credits in the name of tax reform.

Others can, and I am sure will, present in detail the horror of the downturns in historic rehab activity, and particularly specific buildings that have been lost because financing packages weren't able to be put together.

Quite clearly, the record shows that the principal victim of the passive activity rules have been projects that would be put together by limited partnerships that undertake more than roughly $750,000 to $1 million and up in rehabilitation costs. That seems to be the largest package, and as Commissioner Lehman just testified, that is now about the average project in the State of New York.

To return to an exchange between Chairman Rostenkowski and the National Trust's then Chairman Alan Boyd, that you will remember from a 1985, hearing the status of the rehab credits today is that they are broke and they do need fixing. We believe that H.R. 796, the Community Revitalization Tax Act of 1989 is a fair and balanced cure to these problems, and that the time for its passage is as soon as possible.

Our goal is to persuade investors and developers to work on old buildings. The persuader is the tax credits and this bill will restore their utility.

H.R. 796 applies both to the historic rehab credits and to the low income housing tax credit because these provisions can be paired in a combination that seems to be sound public policy.

As you know, fully half of the buildings that have been rehabilitated with the historic credit are now used for rental housing. This pairing between the low income housing credit and the historic credit will be a powerful one that is fully consistent with the National Trust's goals of community revitalization and the creation of thousands of needed units of affordable housing.

At the very top of the National Trust's national policy agenda is remedying the serious defects created by the passive activity rules. As I say at the conclusion of my prepared testimony, because of the impact of the Tax Reform Act of 1986, about 2,000 historic buildings each year are not being rehabilitated and put to a use that simultaneously meets a contemporary economic need and preserves the history of the Nation. That is 2,000 missed opportunities a year to restore vitality to big cities and small town main streets, 2,000 pieces of our heritage that through acts of man or nature, may not be around next year to take advantage of another rehab success.

We urge prompt passage of H.R. 796, and we thank you for the privilege of being with you today.

[The statement of Mr. Walter follows:]

Testimony of

J. JACKSON WALTER

President of the

NATIONAL TRUST FOR HISTORIC PRESERVATION

before the

COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SELECT REVENUE MEASURES

U.S. HOUSE OF REPRESENTATIVES

June 6, 1989

on

THE HISTORIC REHABILITATION TAX CREDIT

"Are you saying, 'If it ain't broke, don't fix it'?"

Chairman Rangel and members of the Committee, this was the question Congressman Dan Rostenkowski posed to the National Trust's then Chairman Alan S. Boyd the last time we had the privilege of appearing before this Committee to discuss the historic rehabilitation tax credit. At that July, 1985 hearing, we were able to answer that question affirmatively.

This Committee adopted our opinion when you voted to retain the historic rehabilitation credit at a time when every tax reform proposal had recommended terminating it. Further, by including a special, limited exception to the newly adopted passive activity rules, the Congress sought to ensure that the necessary equity capital would remain available for historic rehabilitation projects.

Today, unfortunately, we would have a different answer to Chairman Rostenkowski's question. On behalf of the more than 225,000 members of the National Trust for Historic Preservation, I appear before you today to report that the historic rehabilitation tax credit program is broken and ought to be fixed immediately.

The Tax Reform Act of 1986, while keeping the historic rehabilitation tax credit essentially intact, has denied historic rehabilitation projects the equity capital they need. The passive activity rules have all but destroyed the investment incentive that links the nation's historic areas to the investment capital they need to revitalize and thrive. The substantial drop in the use of the historic rehabilitation tax credit engendered by tax reform has been a staggering blow to the nation's historic preservation program. Restoration of the momentum of this highly successful program is a top priority of our members.

We are here to express our strong support for swift adoption of the Community Revitalization Tax Act of 1989 (H.R. 796) as sponsored by Congresswoman Barbara Kennelly and Congressman Richard Schulze. This legislation will restore the investment incentive that the Congress created by enacting and then voting to retain the rehabilitation tax credit. I would like to express our sincere gratitude to Mrs. Kennelly and Mr. Schulze for their leadership on this issue and their sponsorship of this measure and to the Chairman for his support for its enactment.

THE NATIONAL TRUST AND THE HISTORIC REHABILITATION TAX CREDIT

The National Trust for Historic Preservation has advocated the need for federal tax incentives for historic preservation for more than 30 years. We have done this not because of any direct financial benefit to us as an organization or, for that matter, any

direct financial benefit for the vast majority of our members. We have done so because we have long been aware that neither the National Trust nor any level of government can rehabilitate the thousands of historic places in this nation.

It is developers who are in the business of creating housing and commercial spaces. And they will make money whether they rehabilitate old buildings or construct new buildings in the suburbs. Obviously, we want them to invest their time and energy in the work of preserving the nation's heritage. To make this happen, incentives are required.

The historic rehabilitation tax credit has succeeded, as no government program before it, in encouraging the development community to work in historic areas precisely because it has provided a substantial incentive to attract the risk capital of the private sector.

A SUBSTANTIAL RECORD OF SUCCESS

According to the National Park Service, the historic rehabilitation tax credit has encouraged the investment of more than $11 billion dollars in certified rehabilitation projects since its adoption in 1981. The more than 16,000 historic buildings rehabilitated using this credit stand today as functioning contributors to their community's economic health and a tangible link to our heritage. Approximately one half these buildings have been rehabilitated for rental housing including providing housing opportunities to low and moderate income families.

Other buildings serve as anchors of downtown revitalization. Great railroad stations in Washington D.C., Pittsburgh, St. Louis, and Indianapolis, major hotels in Richmond, Philadelphia and San Diego, and commercial projects in Chicago, Baltimore and San Francisco, testify to the impact of this program. Theaters, restaurants, retail stores, corporate offices, and business incubators have been among the beneficiaries of this program. And in small towns and rural areas, the rehabilitation tax credit has been employed to reuse farm structures, main street stores and important community landmarks.

Housing is created, commercial areas are revitalized and rural economies are boosted, thanks to the incentive of the historic rehabilitation tax credit. Every project receiving federal tax assistance must be reviewed at both the state level and by the National Park Service for its consistency with widely accepted national historic preservation standards that are designed to ensure that the best of the old is retained while allowing a contemporary economic use for a property. This review system has been in place for more than a decade and it demands quality and gets it by putting trained historic preservation professionals to work in careful review of each detail of a project.

The historic rehabilitation tax credit has allowed the thousands of local historic preservation organization we count among our members to build strong partnerships with the private development community where there was once antagonism and conflict. The credit has given them a powerful tool to encourage the comprehensive preservation of neighborhoods and downtowns that were once considered shabby and economically unattractive.

Finally, the historic rehabilitation tax credit has created tens of thousands of new opportunities to teach Americans about their community history. The National Trust encourages communities and members of the development community to use signs and other means, where appropriate, to tell the story of the historic places they have rehabilitated.

THE IMPACT OF THE TAX REFORM ACT OF 1986

When Mr. Boyd appeared before the Committee in the summer of 1985, the Congress was considering several tax reform proposals that advocated the termination of the historic rehabilitation tax credit. At that time, we along with the other witnesses before this Committee testified to the enormous success of this program in meeting its intended purpose of encouraging the rehabilitation of thousands of historic buildings and the

downtowns, main streets and neighborhoods they make up.

This Committee affirmed the historic rehabilitation tax credit's substantial record of success in voting to retain it during your consideration of the Tax Reform Act of 1986. Further, by including a special, limited exception to the newly adopted passive activity rules, the Conference Committee considering that legislation recognized that attracting equity capital to historic areas and low income housing projects was the critical objective of the rehabilitation credit and the new low income housing tax credit.

The Limited Exception to the Passive Activity Rules is Not Working

Despite the existence of the limited exception, the passive activity rules of the Tax Reform Act of 1986 have denied historic rehabilitation projects the private investment capital they require. Since passage of the Tax Reform Act of 1986, the National Park Service reports that private investment has dropped by approximately two-thirds from $2.4 billion in fiscal year 1985 to just $866 million in fiscal year 1988. This drop in investment has translated into a steep fall off in the number of historic buildings rehabilitated. The National Park Service received just 1,000 applications for the historic rehabilitation tax credit in fiscal year 1988 compared to more than 3,200 in fiscal year 1984 and 3,100 in fiscal year 1985.

The limited exception to the passive activity rules provided by the Tax Reform Act of 1986 has proven ineffective because:

- the $7,000 limit on the use of rehabilitation credit to offset tax owed on active income is too low to allow the size of individual investment needed to undertake a project,
- the phase out of this $7,000 amount for taxpayers earning more than $200,000 a year has eliminated a substantial number of qualified investors from eligibility for the credit, and
- the rules are complex and force taxpayers to project their passive income, active income and total income prior to making an investment decision.

National Trust surveys prior to the Tax Reform Act of 1986 revealed that limited partnerships were the most popular investment vehicle for undertaking historic rehabilitation projects that would cost more than $1,000,000. In these partnerships, a small number of investors would usually advance between $50,000 and $100,000 each to provide the private equity for a rehabilitation project.

The limited exception to the passive activity rules has not allowed these limited partnerships to continue as a source of capital. First, the $7,000 limit has proven too low to attract the substantial dollars needed to initiate projects. To finance a $1,000,000 rehabilitation project might require $400,000 of equity capital. To raise this amount from investors who could receive a maximum credit of $7,000 a year might require 100 or more investors where previously, five or ten were needed.

Second, the phase out of this limit for taxpayers earning more than $200,000 has substantially limited the pool of eligible investors. Although such investors prior to 1986 made up only a small percentage of taxpayers using the rehabilitation credit, Internal Revenue Service statistics reveal that this income group was responsible for a major share of the dollars invested. Investors earning more than $200,000 a year were responsible for 43 percent of all investments in certified historic rehabilitation projects from 1982 through 1986.

Other investment structures have not filled the financing gap created through the loss of limited partnership capital. Public offerings, permitting project sponsors to raise necessary funds from hundreds of small investors, have proven cumbersome and costly for most developers. Public registration, legal and accounting costs can consume large portions of the capital of a project. Further, individual developers, accustomed to working with a small group of investment partners, have not been willing to try to seek ties with out of town financial intermediaries. The other major alternative capital

source, corporate investment, has never been a major component of the pool of historic rehabilitation investment and has not become one since tax reform.

THE COMMUNITY REVITALIZATION TAX ACT OF 1989

We support the Community Revitalization Tax Act of 1989 as the most direct and effective way of restoring the investment incentive that links private investment capital to the historic areas of the nation's cities and towns. This legislation would remedy the deficiencies of the limited exception to the passive activity rules adopted in 1986 and realize the Congress' goal of providing a continuing, effective incentive for the rehabilitation of historic downtowns and neighborhoods and a substantial new incentive for the creation of low income housing opportunities.

Restores the Investment Incentive

Specifically, by moving the limits on the use of the historic rehabilitation and low income housing tax credits from the passive activity rules to the general business tax credit limitation rules, the legislation would:

- encourage taxpayers to make more substantial investments in historic rehabilitation and low income housing projects,
- increase the pool of investors eligible to use the rehabilitation and low income housing credits, and
- simplify greatly eligibility rules to provide investors more clarity and certainty that they will receive a tax reduction through their investment.

Under the provisions of H.R. 796, investors would be able to receive at least a $20,000 tax credit no matter the source of their tax liability or the amount of their total income. The only exception to this would be where use of credits would trigger the application of the alternative minimum tax. As under current law, the minimum tax, which cannot be reduced by the rehabilitation or low income housing credits, would continue to ensure that no taxpayer can avoid tax liability through investments in historic rehabilitation or low income housing creation. In addition, the losses from rehabilitation and low income housing tax credit projects would remain subject to the passive activity rules.

We project that these changes will restore the incentive for investors, no matter their income, to make substantial equity investments in rehabilitation and low income housing projects. Although the attractiveness of these investment would remain limited by both the general business credit limitations and the application of the alternative minimum tax, we believe that the changes will encourage significant additional use of the historic rehabilitation credit.

Legislation Appropriately Applies to Both Community Revitalization Incentives

We especially support the application of H.R. 796 to both the rehabilitation tax credit and the low income housing tax credit. Both credits share the impact of the passive activity rules and the insufficiency of the limited exception already provided to those rules. The difficulties in obtaining investment capital that have plagued the historic rehabilitation tax credit have also been experienced by those seeking to use the low income housing tax credit. Although corporate use of the low income housing credit has been strong in some areas, we believe that access to the large pool of individual investment will prove to be the key to a long term success for the low income housing credit as it has been for the rehabilitation credit.

In addition, groups that we are working with across the nation are actively seeking to use both credits to create low income housing opportunities in historic buildings. Creating affordable housing has always been an element of the historic rehabilitation tax credit program. The National Trust has encouraged this through our own Inner City Ventures Fund program that assists community groups in low income areas to rehabilitate historic buildings for low income housing in partnership with for profit investors.

The availability of the low income housing tax credit in conjunction with the historic rehabilitation tax credit has enhanced this opportunity and promises enormous success in the future. Consequently, conforming the exception to the passive activity rules for both credits, as accomplished by the Community Revitalization Tax Act, would further encourage the use of these credits in tandem.

CONCLUSION

Mr. Chairman, we urge the subcommittee to take immediate action to support H.R. 796 and to get this program working again. Because of the impact of the Tax Reform Act of 1986, approximately 2,000 historic buildings each year are not being rehabilitated and put to a use that simultaneously meets a contemporary economic need and preserves the history of the nation. That is 2,000 missed chances to return vacant deteriorated buildings to the housing stock, 2,000 missed opportunities to restore vitality to big city centers and small town main streets, and 2,000 pieces of our heritage that, through acts of man or nature, may not be around next year to become another rehabilitation success.

Through speedy passage of the Community Revitalization Tax Act of 1989, you will restore the crucial investment incentive that generates the investment capital these programs need to function. You will guarantee the continued success of the historic rehabilitation tax credit program as this Congress intended in 1986. In addition, you will give the low income housing tax credit program the best chance to succeed.

Mrs. KENNELLY. Thank you for your testimony, Mr. Walter. Nellie Longsworth will now make her statement.

STATEMENT OF NELLIE L. LONGSWORTH, PRESIDENT OF PRESERVATION ACTION

Ms. LONGSWORTH. For the record, I am Nellie Longsworth, president of Preservation Action.

My personal career as a grassroots lobbyist has been spanning the years that we have had tax incentives for historic structures. It started at the end of 1975 lobbying for tax reform in 1976 and the first 5-year amortization tax incentive for rehabilitation.

I will say that it's been a full-time career over these 13 years because we are either supporting or opposing the various changes that have come about almost on a biannual basis.

When I started back in 1975, everybody had coffee table books called "Lost Chicago," "Lost Philadelphia." You know, all the cities where many buildings had been lost to urban renewal.

We also talked about gritty cities. Those were the cities that in 1976 had blighted downtowns. However, these cities did have infrastructure in place, they had a history of economic success in many of the blighted areas and they also had craftsmanship and beauty in the buildings that were hidden by neglect. At that time, we fought for tax incentives because we felt that we wanted rehab of our cities to be as important an opportunity for investment as oil and gas exploration, as, supporting a race horse, as backing a Broadway show. We were successful and, in fact, that's exactly what rehab did become; a competitive investment alternative.

By the eighties, the rehab credits had really taken their place. And by 1984, I had the chance to go to 40 cities in 4 months. In all these cities, I saw first hand what had happened. I saw that rehab produced jobs, that neighborhood people had become involved. I saw housing being created out of the older buildings in neighborhoods for low- and moderate-income people, for senior citizens.

There was a return of tax base to the city. Stabilized neighborhoods reduced crime. And there was a distinctiveness, a quality of life and ethnic character that had been preserved in each city; 1986 was a bittersweet victory in saving the credits. Yes, we had a credit, but it was made unworkable by the passive loss rules. Rehab was stopped in its tracks. One person who was unable to testify today was Tom Kuber from Menominee, MI, a town of 11,000. He had been able to talk his business associates into investing in the mid-downtown blighted area to help their little town of 11,000 come back.

He said 1986 and tax reform stopped the rehab project in midstream. Those projects that were done were done, the others were never to be done until we make the credits workable again.

The Community Revitalization Act is needed as all these statistics have shown. We have many buildings waiting in the wings. We have neighborhoods waiting for help. We have development pressures in cities that during good economic times are continuing to bulldoze their way into our older commercial districts and neighborhoods.

Preservationists need the rehab credits to convince owners and developers of the merit of rehab rather than demolition and replacement. Preservationists need the rehab credits to convince city government to develop plans that include historic areas in growth and development schemes.

We believe that the Community Revitalization Tax Act is not returning loopholes to the code; it is not changing passive loss rules as they relate to losses. It is treating credits as credits. It is increasing the potential investor pool for both rehab- and low-income housing.

One interesting fact that we learned in 1985 from a study done in the State of Illinois by Shlaes & Co., was that certified rehab projects virtually return all of the investment tax credit to the Federal Treasury in the form of other taxes paid later through the sale of the projects and taxes on gross earnings generated by rehab. They figured of all the projects done over an 8-year period in the State of Illinois, that 88 percent was returned to the Treasury, which meant it was a good Federal return on 12 percent of a dollar.

Preservation action has found very strong grassroot support for something that works so well.

We have asked our activists to seek support from their city leaders, the mayors, the city councils, the chambers of commerce. We started at the end of April and already we have 40 resolutions from around the country. We expect another 10 by the end of this week, and we believe there are about 100 in process.

Now, the rollcall of support, includes Kansas City, Kirkwood, Hannibal, MO.; Lincoln, Omaha, NE; Coral Gables, FL; Covington, Bardwell, Shelbyville, Boone, KY; Vicksburg and Columbus, MS; Chattanooga, TN; Yoakum, TX; Cunard, Crockett in Houston County, TX. It includes the State of Utah, Providence, RI; Minneapolis, Faribault, MN; Orange County, CA; Vermont. In New York City, the mayor just signed a resolution today.

Therefore we commend the subcommittee, and we commend those of you who are here for your cosponsorship of this legislation and for holding this hearing. And we will be actively involved in seeking enactment of this measure in both the House and the Senate in the weeks ahead.

Thank you very much.

[The statement of Ms. Longsworth follows:]

PRESERVATION
Action

TESTIMONY OF NELLIE L. LONGSWORTH
PRESIDENT OF PRESERVATION ACTION

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
HOUSE OF REPRESENTATIVES

JUNE 6, 1989

I am Nellie L. Longsworth, President of Preservation Action, the national citizens lobby for historic preservation. I am pleased to testify on behalf of the Community Revitalization Tax Act - H.R. 796 - and its critical importance to older communities and neighborhoods throughout our nation.

I have been actively involved in lobbying the Congress on preservation-related tax issues since 1975, the dark days for owners of historic properties. At that time, our nation had emerged from a 30-year period of dramatic social and economic change. The interstate highway system had spawned suburban development throughout the nation, sapping the energy from urban centers and relegating areas of center cities to those who did not have the means to move out. Urban renewal did not prove to be the panacea for social problems and many older areas of cities sunk deeper into decay.

I entered the preservation field during the days when the federal tax code offered generous incentives for new construction but kept those interested in rehabilitating historic buildings at a disadvantage by offering only straight-line depreciation. The greatest problem, however, was the provision of the tax code which encouraged the demolition of historic buildings by allowing deductions and reduction of basis for the destruction of any building, including historic buildings. We saw such gems as the Chicago Stock Exchange Building - one of architect Louis Sullivan's finest - fall to the wrecking ball with a mundane building erected in its stead and tax advantages to the owners.

As a green preservationist and lobbyist, I found few on Capitol Hill aware that federal tax policy was encouraging the destruction of our heritage. Where I did find solace was in a small number of bills - known as "Environmental Tax Acts" or "Historic Structures Tax Acts" - which proposed incentives for the rehab of historic structures. The Congressional innovators included Rep. John Byrnes (R-WI) who introduced the first historic preservation tax incentives for then-President Nixon, Rep. Barber Conable (R-NY), the ranking minority member of the Ways and Means Committee in 1976, who bird-dogged tax incentives for the built environment, Sen. J. Glenn Beall (R-MD) who introduced a floor amendment to the 1976 Tax Reform Act and Sen. Russell Long (D-LA) who rallied the Senate to its support.

The victory of 1976's Senate floor amendment that became law also became history in awakening America to the beauty and utility of reusing historic buildings. With incentives of five-year amortization and double-declining balances, building owners and developers began to view the rehabilitation of historic structures with renewed interest, overcoming the "new and bigger is better" as the only response to change. Ways and Means Committee oversight hearings chaired by Richard Gephardt(D-MO) in St. Louis on December 11, 1978 showed the wisdom of incentives for rehab but also clearly pointed out the continuing disparity between tax incentives for new construction and those for rehabilitation of existing historic structures. In 1980, Chairman Dan Rostenkowski (D-IL), proposed a sliding scale of tax credits for the rehab of older and historic structures in a Chicago speech as a means to further encourage reuse of older buildings and neighborhoods throughout the nation. This suggestion ultimately found its way into the Economic Recovery Tax Act of 1981.

Testimony today reinforces the wisdom of the investment tax credit approach to the rehabilitation of historic and older commercial, industrial, retail, and residential structures. The success of the credits in local communities became measurable when the "first rehabilitated building on the block" spawned other owners and developers to undertake adjacent projects. The

benefits to the community were many:

* the labor intensity of rehab work created jobs, often for neighborhood people;
* the return to productive commercial use of buildings formerly boarded up or underutilized meant tax base dollars flowing again into local community and state coffers;
* the return of business and rental housing to the neighborhood meant a return of stability, a reduction in crime;
* the reuse of existing buildings with infrastructure already in place saved both energy and our heritage.

Sound older buildings found new uses in a modern world, further benefitting communities by becoming showcases for the craftsmanship and architecture of another era.

And there was more. This program, responsible for turning around national attitudes about historic buildings, was accomplished through private citizen investment with little administrative overhead. Through the cooperation of the Treasury and the Department of Interior, a universe of historic buildings eligible to use the 20% credits was limited to those listed on the National Register or in districts approved by the Secretary. Further, the treatment of the historic building was guided by the Secretary's Standards for Rehabilitation which insured that the historic character of the buildings was retained. If the rehabilitation did not meet the Standards, the tax incentive was denied.

Washington, DC enjoys many of our nation's finest examples of historic rehabilitations that meet the Secretary's Standards. It also exhibits a number of well-known "historic" buildings that DID NOT meet such Standards and were not eligible to take the historic tax credits. The Evening Star Building, Red Lion Row, the Army-Navy Club, the Homer Building, the Colorado Building - in fact all those projects that only retain the facades of the proud historic structures they have replaced - are not historic rehabs and did not receive one penny of rehab investment tax credit. On the other hand, the Apex Building, the Willard Hotel, the Old Post Office, and numerous small office and apartment structures have successfully met the Standards and have become showplaces and economic successes.

The nation responded positively to the investment tax credit program in the early 80's, and not surprisingly, the larger cities responded most quickly. St. Louis, Philadelphia, Hartford, Charleston, Providence, Boston, San Antonio, and Seattle were some of the leaders. Slowly, smaller cities - "Main Street Cities" - began to see that the credits would bring business back downtown, however, they were entering the arena as the tax credits became threatened by possible repeal of all tax credits in the tax reform proposals of 1984-5. The climate surrounding tax reform discouraged all but a few from beginning the revitalization of "main street". Those who began the process, such as Tom Kuber in Menominee, MI, found support from the business leaders of his town of 11,000 under the old laws but found his downtown project placed on the back shelf when local investors saw the diminution of incentives under the passive loss rules of Tax Reform in 1986.

The battle to "save the rehab credits" in 1985 and 86 was a strong national grassroots effort to continue a credit that really worked in every region of the nation and in small towns as well as larger cities. Statistics gathered by the National Park Service showed that the average size and dollar value of projects was small, often considerably less than $500,000 and that citizens of these smaller cities became the backbone of the grassroots lobbying effort for change.

It has been 2 1/2 years since the enactment of the 1986 Tax Reform Act and the bitterweet victory in saving the rehab credits. Preservationists, developers, and communities have tried to continue under the changes but National Park Service statistics confirm that the rehabilitation of older, historic buildings has suffered a dramatic reduction in number of buildings rehabbed and dollar value of investment. Of great concern to many is that the economy has not slowed and that historic buildings and neighborhoods - now more than ever - are becoming the prey of developers and foreign investors who seek sites upon which to erect shiny new office buildings. Without tax credits offering the incentive to "save rather than demolish and rebuild", we can expect to see continuing erosion of our historic building stock.

Preservation Action is a national grassroots lobby for historic preservation whose members are working actively for enactment of the Community Revitalization Tax Act - H.R. 796 introduced by Rep. Barbara Kennelly (D-CT) and Richard Schulze (R-PA). We all want our cities and communities to grow and prosper. We know that the revitalization of commercial and residential historic buildings can provide affordable space

for new businesses and low-income tenants. We know that historic areas retain the distinctive character of a city and bring pride to ethnic populations such as we have witnessed in the revitalization of Lowell, MA. We know that commercial activity flows to revitalized areas, such as the West End of Dallas, Pioneer Square of Seattle, Portland, ME and Saratoga Springs, NY. We know that "carrots" such as rehabilitation tax credits established to attract private sources of funding to preservation work very effectively.

The decline in the use of the rehabilitation tax credits under tax reform has hit communities of all sizes throughout the nation. The preservation community was skeptical that corporations would take up the slack of individual disinterest caused by the passive loss restrictions. Our pessimism has been sustained.

In short, we find that the congressional intent to retain incentive for commercial and residential rehabilitation of qualified historic properties has been short-circuited by counteracting provisions of the 1986 Tax Reform Act:

* a $7,000 limit on credit use per year is of minimal interest to most investors;
* the pool of investors eligible to underwrite historic rehabilitation has been substantially reduced by income limits;
* corporations have not leapt into the void as some predicted would happen;
* the transactional costs of marketing public partnerships has produced financing for large projects only;
* mid-sized projects - from $750,000 to $3 million - have almost come to a halt.

We fully understand the reluctance of Congress to open up the passive loss rules of the 1986 Tax Reform Act. The solution proposed in H.R. 796 for both the rehab and low-income housing credits, however, does not change the rules as they apply to losses in the rehab or real estate market. It does remove the treatment of the credits from that of being an "exception" to passive loss rules to provisions guiding the individual taxpayer's use of general business credits. Simply, it encourages investors for all income levels but offers no loopholes for getting around one's fair share of tax liability.

Lastly, Preservation Action's membership of 1,200 organizations and individuals are vocally supporting the enactment of H.R. 796. In surveying non-profit preservation organizations throughout the nation, all respond that their local city leaders are unanimously in support of the "fixing of the rehab credits". Since April of 1989, city councils, mayors, historic district commissions, and chambers of commerce have been approached to officially enact resolutions in support of the credits. Thirty-five resolutions have been completed from coast-to-coast with 100 more in process. Members of Congress are being contacted as the resolutions are completed, asking for their additional support when the Community Revitalization Tax Act comes to the floor for a vote.

The success of the Community Revitalization Tax Act is important to all communities from Anacostia, DC to Yoakum, TX, from Chicago to Vicksburg, MS, and from Coral Cables, FL to Faribault, MN, from Louisville, KY to Providence, RI. Let's put the dark days for our heritage neighborhoods and commercial areas behind us. We request your positive action on H.R. 796.

Mrs. KENNELLY. Thank you very much.

May I ask you the first question of the panel as a whole?

Did any of you expect that the dramatic dropoff that did result from the 1986 act?

Now, let me take a step further. You have studied every inch of this. Do you find anything else in the 1986 Tax Reform Act that might have caused this problem, was it the passive loss rules that did it?

Mr. WALTER. Well, Mrs. Kennelly, I think, as you remember, from some late nights in the passage of tax reform, we had in fact anticipated a downturn. I'm not sure that we can say we anticipated it at the level at which it's happened.

But surely we expected a substantial downturn and predicted it, talked with the chairman at that point and suggested that was likely to happen. And in fact now it has been documented by everybody from anecdotal to national statistics from the Park Service.

Are there other contributing factors? Of course there are. But I don't think any of those factors in terms of scale or quantity of the magnitude of the contribution to the problem come close to a factor that it is in the same order of magnitude as the passive activity rules.

I'm sure that, at some level, the cut in marginal rates probably did something. I am sure that the cut from 25 to 20 percent did something. But, in terms of the scale of the downturn, no, I don't think there's anything else that's really on the charts.

Mr. ANDREWS. Would the gentlelady yield for a question?

Mrs. KENNELLY. Certainly.

Mr. ANDREWS. And so then the testimony of the Treasury Department earlier today that we needed additional study on the specific issue that Mrs. Kennelly has just asked about, do you believe, Mr. Walter, it's not necessary?

Mr. WALTER. That's correct, Mr. Andrews. We think that the information is absolutely clear that the passive activity rules are the principal contributing role.

Mr. ANDREWS. So, regardless of the economic downturn in Texas which I'm sure had an impact, not just on historic rehabilitation, but on development across our State. That still is not so significant as to affect the trend as much as the passive——

Mr. WALTER. Not when we're talking about the trend as a national one, I believe that's correct, yes, Mr. Andrews.

Mr. ANDREWS. Thank you.

Ms. LONGSWORTH. Could I answer that question, also?

Mrs. KENNELLY. Oh, sure.

Ms. LONGSWORTH. Please. We had hoped that there was going to be an exception of $25,000 tax credit allowed, when they were working on this in 1986. And, we were really very upset when the words were added, "offset of tax on $25,000," because that limited the allowable credit to $7,000 per year.

We were also concerned from the very beginning that a very large number of investors were excluded by the income caps from even being able to reinvest in rehabilitation. We knew they were going to continue to seek investment opportunities, but would not be eligible to invest in rehab.

So, we could see the minute we began to look at the results of tax reform in 1986 that the chances of its success were very slim. Real estate activity is not as affected as construction cranes are up everywhere in some cities, real estate activity has not ended where there is strong economic forces still pushing it.

Mrs. KENNELLY. Well, just to take Mr. Andrews' remarks a little further, Treasury said as do so many people, "Well, we've got this budget deficit. Why do this now?"

What would your answer be if that was said to you?

Ms. LONGSWORTH. Well, my answer is that it is the private sector doing a job that is desperately needed in older areas of the city. These are older neighborhoods. The infrastructure is there. There are savings that we are going to gain. It does create jobs. It does things that are desperately needed.

I think the alternative of going back to the period of decay benefits nobody. Then, it means that we are going to have to come through with appropriations and do the job which is, of course, invokes more overhead, and is not as efficient as this particular program has been.

Mrs. KENNELLY. This is a priority that we better not wait too long or we will not have the choice.

Ms. LONGSWORTH. We will not have a choice.

Mr. WALTER. Mrs. Kennelly, I would just also like to add to what Nellie has said by saying that there are also very specific buildings that are right now at risk, and there is urgency here on the economic side about putting matters right that is not evident when we are talking about national charts.

But, there is also, in Commissioner Lehman's home State, the Roycroft Inn. The Roycroft Inn could simply not be there in a couple of years if we cannot get to work on that, and we cannot put together, and the local people in upstate New York cannot put together a financing package without these credits.

Mrs. KENNELLY. Well, our Bigelow Mills project was exactly like that.

Mr. WALTER. In your new Speaker's hometown of Spokane, the Davenport Hotel is right now sitting there empty, controlled by Lomas & Nettleton from Dallas, and they cannot put together a financing package.

If we do not get at the Davenport Hotel in the next year or so, you are going to start to see very substantial deterioration of the building, which is a regional landmark of massive proportions.

So, it is not just the charts and the numbers, but it is specific named buildings of major historic importance around the country that we will lose. We will start saying we lost buildings so the urgency is there. Obviously, from the National Trust's point of view, the urgency is there on specific historic buildings around the country that we want to see saved as being potential anchors for downtown revitalization in regions all across the country.

Mrs. KENNELLY. Can we talk about that a little bit? There has been a certain amount of moneys, invested in rehab projects. I have the National Parks Service number right, $866 million in fiscal 1988. Some 1,100 projects were approved.

Can we talk a little bit about what is being done, what is viable, what are we losing? Why are these 1,100 projects being done and yet that dramatic dropoff exists? Would you enlighten me on that?

Mr. LEHMAN. Well, I do not know if I quite understand your question. I think old bill——

Mrs. KENNELLY. Well, we have had 1,100 projects approved?

Mr. LEHMAN. Yes.

Mrs. KENNELLY. We have had $866 million spent in the last fiscal year on rehabilitation.

Why those projects and why are the other projects not happening?

Mr. LEHMAN. Well, ours has dropped a great deal in our State, and there are still some people that are going forward with it. There are some areas where whole small towns, particularly, have benefited greatly. The whole town has been revitalized economically as much as in terms of historic preservation by these credits.

Of course, there are some very large investors that are doing it. The Plaza Hotel is being redone. I imagine there will be some tax credits there, but that is a landmark in New York and everybody pretty much knows about it. It is a terribly important building in New York.

It is happening in small towns and in large towns, in the cities, too, of course. I think it just brings so much economical revitalization. Once they started, they keep moving, but it has dropped off dramatically.

Ms. LONGSWORTH. It does turn out, I think, to be your small projects, a lot of "mom and pop" projects.

Mrs. KENNELLY. That is what I was wondering about.

Ms. LONGSWORTH. And, those are going on partly because people can get them done by the end of the tax year. You know the tax law is changing so quickly that people are not willing to be moving ahead and buying real estate and investing in four to five buildings on a block. So, we are getting into the piecemeal.

We have seen that some of the large projects are going forward. Some of those have been planned, some for many years were grandfathered in the 1986 act. We see projects between $750,000 and $3 and $4 million just not happening for the most part. Those are the ones that are needed. Those are the buildings that are going to be——

Mrs. KENNELLY. Those are the ones that begin to reform the community?

Ms. LONGSWORTH. Reform the community, yes.

Mrs. KENNELLY. Mr. McGrath.

Mr. MCGRATH. Thank you, Madam Chairman.

Let me first and foremost welcome the panel. I am sorry I was detained for part of your testimony. I have the gist of it, however, and let me specifically welcome Commissioner Lehman from the State of New York to this distinguished panel. Mr. Lehman has been a longtime commissioner of parks and recreation and historic preservation, and has done a good job. We are all proud of him for the work he has done.

Having said all that, let me tell you that I am not one of the people on the panel who gets emotional over buildings, even old

ones. I do get emotional over economic revitalization and the use of the Tax Code for those purposes.

I have listened to the three of you talk about the change in the passive activity rules as being a major component in the number of projects that are now being carried out. I must tell you that the House Ways and Means Committee did not touch the passive activity rules during its deliberations of the tax reform bill. It came out of the Senate, and we are not taking any credit or blame for that, but it was a conference situation.

However, it did produce for us $57 billion over 5 years for what many people thought was a tax shelter abuse for the rich. Frankly, in the atmosphere we find ourselves in today, our only alternative may be to redefine what an active investor might be. This may create a revenue loss that could be palatable.

I do not see, however, a return to the past acceptance of passive losses.

Now, besides these suggestions, what can we best do to create this economic revitalization in our inner cities beyond the enactment of the bill 796?

Ms. LONGSWORTH. I will be glad to take a shot at that.

I feel very strongly that we are not asking to change the passive loss rules. The credits are within the rules as an exception to the loss rules. we are just asking that the credits be treated as general business credits with the general business credits also being reduced. It is a tradeoff, but it is treating credits as credits and just moving them into another existing section of the Tax Code.

It is not changing the loss rules as they affect rehab or effect any other passive activity.

Mr. MCGRATH. I am not suggesting that they were, but I am suggesting that if it is the No. 1 priority, or the one thing that has reduced the number of rehabilitation sites, then obviously most people in this room today would like to see the return of passive loss. I just do not see it happening in reality.

I am finished, Madam Chairman.

Mrs. KENNELLY. Mr. Andrews, do you have any questions?

Mr. ANDREWS. Just one.

So, I gather, then, from the panel, that if we do not take action, the lines on the chart will continue to deteriorate until we find ourselves in a pre-1978 condition?

Mr. WALTER. Mr. Andrews, I think that is correct.

When you analyze where the money is coming from that is going into this field, I just do not see anything that is going to restore the flow of funds that are not coming into it now. I don't foresee some other kind of investor that is not affected by these rules who will suddenly decide to get involved in this field.

One of the things that I think we have to bear in mind is that we have an enormous success record here. We could probably redesign, Mr. McGrath, some different kind of program. But, all of a sudden, you would wind up having another learning curve to go through, and it is unlikely that it would work as well as this one has.

We have what seems to be a fairly tightly drafted cure for a fairly specific well foreseen and anticipated problem, and as Mrs. Longsworth said, we have tried to say we are not exempting something from the passive activities rules, but we are moving over into

the general business credit rules to treat this the same as we are treating other kinds of business credits.

That seems to me to be a fair approach. It is a reasonable one. I do not think that you are going to see a return of the rehab credits to their lofty days—if 1984 was the high year, I do not think that you are going to get back to that. But, I think we would like to move back to a level that more closely approximates where we were a few years ago and not continue or fall off even more.

Mr. MCGRATH. Thank you. You have all been a fine panel. Thank you.

Thank you, Madam Chairman.

Mrs. KENNELLY. Thank you very much for your expertise and for sharing it with us by coming here today.

The next panel will be the National League of Cities, Pamela Plumb, past president, city council member, Portland ME; and Kentucky Main Street Program, Scott Barksdale, coordinator.

Ms. Plumb, you may start. I want you both to know that your entire testimony will be placed in the record.

STATEMENT OF PAMELA P. PLUMB, CITY COUNCILOR, PORTLAND, ME, AND PAST PRESIDENT, NATIONAL LEAGUE OF CITIES, ON BEHALF OF PRESERVATION ACTION AND THE NATIONAL LEAGUE OF CITIES

Ms. PLUMB. Thank you very much. Representative Kennelly, Representative McGrath, my name is Pam Plumb. I am city councilor in Portland, ME. I am also the immediate past president of the National League of Cities.

I will not read my testimony to you. You have it for the record. I will not take your time to do that. I also have a plane which leaves for Portland, so it is in our mutual interest for me to be brief this afternoon.

But, I very much appreciate the opportunity to be here today and speak on behalf of a piece of legislation about which I feel very strongly.

As my testimony indicates although I have spent the last decade as an elected municipal official in the city of Portland, I spent the previous decade working in historic preservation. I need to explain to you a little bit about the city of Portland, ME.

We are a city of 65,000 people. That is not a very big city. That is a pretty small city, but we are the biggest city in the State of Maine, and we therefore have, for better or for worse, all the attributes of a big city and all the inner-city issues that larger cities face.

Our city is an ancient one by American standards. It was founded in 1632, and we are blessed with much of our architectural heritage, certainly reaching back as far as 1790 and 1800. That is very important to us in our community.

My focus today and in the report which you can read for yourselves is really on historic rehabilitation and on historic preservation. I do not mean by that emphasis to deemphasize the importance of low-income housing, which is also a part of what is being dealt with here, and I wish to say that although I have not dealt

with it extensively in my written testimony that is very important to our community.

The Portland experience, I think, could be very illustrative of the work that has been done through the rehabilitation tax credit program. We stand as a community which is almost a miracle created by the kinds of tax credits generated first in 1976 and then in 1981.

Picture for yourselves an older New England community which basically went into the depression before the depression and did not come out of the depression until the 1970's. When I first began in historic preservation in 1969, we had had no new office building in 40 years in the city of Portland. There was one office building built in 1969. There was one more built about 1974. We were just beginning an economic revival which we desperately needed.

What we did have was a reservoir of beautiful 19th century and early 20th century buildings, both commercial and residential, in our inner city. They were largely underutilized, vacant and decrepit, but they were there.

Thanks to the Historic Structure's Tax Act of 1976 and the subsequent act in 1981, we saw extraordinary renovation in our inner city in Portland, both commercial and residential renovations spurred by this tax act.

We did, from 1978 to 1988, 83 projects totalling a little more than $88 million. That is an extraordinary amount of activity for a community our size.

It had more impact than just that investment in our community. A report which was done in 1985, and these numbers would be larger now because there were significant activity in 1986 as well, showed that we had then done 71 projects covering 156 buildings to the tune of 66 million dollars' worth of investment.

As a municipal official, I must tell you that had a significant increase on our valuation as a community. It increased our total valuation some $57 million, and it increased our taxes assessed per year by $1,546,000.

Now, I understand in Federal terms that is not very large, but you must understand our whole municipal budget on the city side runs about $87 million. So, we are talking a significant increase in our revenue stream. So, that had a very large impact on us.

In addition to that, we saw an impact of new jobs to the tune of 2,640, new earnings to the tune of $49,236,000, and new sales, which generated sales tax for the State—sadly not for us, but at least for the State—of $155 million.

Those are significant impacts for a community our size, and visually, physically, and even spiritually for a community which has been down at the heels for a long time, that kind of renovation, that kind of injection of capital and interest in our inner city was very, very significant.

You should know that of the 83 projects that we are talking about, 81 of those were all inner-city peninsular projects.

I would only say in closing that I certainly view this piece of legislation as a way to restore for us an ability to invest, an ability to invest in our community which will generate a return in the community, generate a return to the State government, and generate a return to the Federal Government.

Thank you very much for this opportunity. I appreciate it greatly.

[The statement of Ms. Plumb follows:]

STATEMENT OF

PAMELA P. PLUMB, CITY COUNCILOR, PORTLAND,ME

FOR

PRESERVATION ACTION

AND THE

NATIONAL LEAGUE OF CITIES

Mr. Chairman and members of the Committee, thank you for the opportunity to testify today on the Community Revitalizationa Tax Act of 1989 or HR 796. My name is Pamela Plumb. I am a City Councilor in Portland, Maine and the Immediate Past President of the National League of Cities. For the last decade I have served as a local elected official, and for the ten years prior to being a Councilor I worked in historic preservation with Greater Portland Landmarks. Both as a municipal official and as a preservationist, I come before you to emphasis the importance of the legislation under consideration today, HR798.

The Tax Reform Act of 1986's passive activitiy rules have significantly reduced the ability of the rehabilitation tax credit and the low income housing credit to preserve old and historic buildings and create low income housing opportunities. Consequently, the rules have served to frustrate Congress' goal of providing substantial tax incentives to encourage the revitalization of the nation's older commercial areas and low income and historic residential neighborhoods.

The passive activity rules limit annual use of the rehabilitation and low income housing credits, for many taxpayers, to $7000. per year. In the case of many taxpayers earning more than specified income limits, the

rules deny all use of the rehabilitation and low income housing credits.

These rules have led to a sharp decrease in the availability of equity capital for rehabilitation and low income housing projects. As a result, the use of the historic rehabilitation tax credit has declined by approximately two thirds from pre-tax reform levels. In addition, the use of the low income housing credit has remained well below expectations.

The Community Revitalization Tax Act of 1989 would restore the vitality of these tax credits and still ensure that limits on credit use are maintained. The legislation accomplishes two important changes. First, it exempts the rehabilitation and low income housing credits from the passive activity rules. Losses from such projects would remain subject to the rules. Second, it tightens the existing limitations on individual taxpayer use of all business tax credits including these.

These changes would permit taxpayers to use $20,000 of credits in a year plus an amount equal to 20 percent of any additional tax liability they might have. Credit availability would no longer be tied to a $7000 limit or be based on the amount of passive income a taxpayer could claim.

The Community Revitalization Tax Act of 1989 would increase the pool of investors eligible to use the rehabilitation and low income housing credits, reduce transaction costs by expanding the number of practical financing mechanisms and simplify the use of these credits by applying uniform eligibility rules to all taxpayers.

I do not come before you today as a tax expert, which I most certainly am not, but rather to give you some insight into the impacts of these tax credits on our community, particularly from the perspective of the rehabilitation of historic buildings.

Portland, Maine is a city of 65,000 people. We were founded in 1632 and grew to be a significant port before

the revolution. In spite of near total distruction in the Revolution and again in a devastating fire in 1866, our central city is a rare fabric of historic buildings and places from our 1690 Eastern Cemetery and 1800 Federal style buildings to our spectacular new I.M. Pei art museum. We cherish our history at the same time that we strive to become a modern, economically viable city.

When the Historic Structures Tax Act was passed in 1976, Portland was just beginning its economic recovery and growth. This act and the additions made in 1981 were the driving force behind the rehabilitation of the many historic buildings in our central business district and in our historic inner city neighborhoods, which were coincidentally our primary low income neighborhoods. We saw developers take buildings which had been neglected for generations and in some cases were vacant and invest significant sums to rehabilitate them, to give them new life and uses, to make them contributing parts of our community again at the same time that they save the historic fabric of our city.

In the decade between 1978 and 1988 there were 83 projects done worth $88,55,694. That is a stunning amount of activity for our little city which had seen little or no building or rehabilitation of large structures from the depression to 1970. A 1985 report on the program, which covered 71 projects for a total of $66,000,000, showed an increase in City tax valuation of $57,650,673 from 1975-1985 due to those projects and therefore an increase in property tax collections of $1,546,025 for the City. In addition the report catalogued significant other economic and social benefits. In summary it said:

"In Portland, the $16.5 Million in Investment Tax Credits allowed under the Tax Reform Act of 1976 and the Economic Recovery Act of 1981 will result in gross private investments in excess of $66 Million in rehabilitation of 156 historically significant buildings by the end of 1985. The adaptive use of these previously empty or

underutilized buildings will create approximately 484 new housing units. In addition, to direct rehabilitation expenditures, 2,640 new jobs will have been created, earnings will have increased by $49.2 Million, sales by $155.1 Million and real estate taxes by $1,546,025 a year."

Those figures show an extremely high return for a modest tax credit investment.

However, since the 1986 Tax Act, there has been a significant decline in rehabilitation tax credit investment in Portland as well the rest of the country. Prior to 1986 we averaged over 11 projects a year. After 1986 it has dwindled to 2.5 a year. As we face a slow down in our economy and a continued crisis in low income housing in our area, we need these incentives more than ever as a catalyst to private investment. The Community Revitalization Tax Act will help to restore these tax credits to their proper effectiveness.

In closing, I would like to underscore the intangible significance of the work accomplished by these tax credits in addition to the dollars of private investment, the jobs and the property tax valuation. Perhaps you recall the famous line from the Grapes of Wrath as the grandfather is being chastised for packing into the overladen family truck a few knickknacks and photographs. They seemed so impractical for the long trek west in search of a better future. He said " How will we know it's us without our past?" The same is true for cities. How will we keep our sense of roots and teach our children the significance of their heritage, if we do not encourage investment in the historic, architectural fabric of our communities. Old buildings may need new uses in this modern age, but the old clock tower of the North School remains a landmark even though the building is used for congregate housing, the greek revival columns and the Queen Anne turrets are still a part of the communmity fabric. The tax credits have been an instrumental part of giving preservation a chance. Without them the economics will tilt back in favor of demolition. Then " How will we know its us without our past?"

Mrs. KENNELLY. Thank you, Ms. Plumb.
Mr. Barksdale.

STATEMENT OF SCOTT BARKSDALE, PROGRAM COORDINATOR, KENTUCKY MAIN STREET PROGRAM, KENTUCKY HERITAGE COUNCIL

Mr. BARKSDALE. Yes, ma'am. I would just like to reiterate what was said in that I appreciate the opportunity to be part of this forum today, and it is a privilege and an honor for me to be representing the Commonwealth as well as the Kentucky Main Street program.

Our program is housed in the preservation office, and we are just a part of a much larger program, the National Trust for Historic Preservations program, the Main Street program for downtown revitalization.

I would simply like to give you a scenario, if you will, of what we are doing with Main Street, and how important what you are considering today has and what type of impact it is going to have on us over the long run.

The Main Street program is currently operating in 29 States with over 500 participating communities, and one of the four points of the program is the economic restructuring point, and I would like to talk about that.

Part of that point of the program is the creation of local incentives and the use of existing use incentives to leverage reinvestment in the downtown. And, that is a key ingredient to the revitalization process.

Up until 1986, we were able to put together a development package which included the rehabilitation credit with other local incentives. But, unfortunately, we are not able to do that today in Kentucky. We are doing it not very much, in any case.

In early 1988, we at the Kentucky Heritage Council, along with the Kentucky Municipal League, rendered a grant to the University of Kentucky and we undertook an economic study on the effects of the tax credits in a community called Bowling Green, KY, which is in southwestern Kentucky.

Bowling Green is a community of 42,000. By our standards in Kentucky, it is large. By national standards, it is a very small community. I want to give you some figures, and those figures are simply, I think, they are very impressive.

For a community of 42,000, they had 19 rehabilitation projects which generated a total reinvestment of $3,981,000. Of this, there was also 40 other rehabilitation projects and 10 new construction projects in the downtown with additional investments of $14.8 million.

The total investment of more than $18 million, produced 57 new net businesses and 14 additional housing units in the downtown.

During this study, part of what we asked to those developers was the importance of the tax credit and whether without the credit would that project have taken place. Ninety-two percent of the developers that were interviewed said that the tax credit was either important or very important in their decision to carry out the project. Their renovation efforts increased the tax receipts nearly

$734,000 for the community itself. They created 232 new jobs, and they had an increase gross output of more than $9 million and increasing earnings of more than $3 million to the community.

Other benefits that have already been reiterated, again, the enhancement of the downtown, an improved image of the downtown, and pride in ones community coming back to the people of the community.

This particular case study, I think, if nothing else is a window which can be reflective of Kentucky, and then indeed of the Nation. Kentucky, basically, is a very rural State. The largest community or city we have in Kentucky is Louisville, and by our means it is large. But again, it is not even 1 million.

But, in Bowling Green after the 1986 tax credits, changes were made. We have only had two projects take place. I think that is indicative of the situation across the Nation, indicative of the other coordinators in my position that I talked to throughout the year as far as downtown revitalization projects taking place.

Going beyond Bowling Green and moving to the State of Kentucky as a whole, we saw 256 tax credit projects undertaken in the 18 Main Street communities that we were involved in from 1980 through 1986. With a total investment of over $81 million.

Seventy percent of those took place between 1980 and 1986. That would have been closer to 90 percent had it not been for the city of Covington, and Covington utilized some repaid moneys from UDAG grants and CDBG's to offset the dilating of that incentive.

In closing, I would like to say simply one thing, and that is if the downtowns of America are the hearts of our communities, both large and small, if their history, their architecture, and their heritage are worth saving, not only worth saving but worth reestablishing to provide the incentives—reestablishing is part of the commerce of today—then we all have a responsibility to provide the incentives for that to happen. Responsibility lies with us as individuals with the local communities, with the States, and with the Nation.

Mrs. KENNELLY. Mr. Barksdale, could I interrupt you a moment?

Mr. BARKSDALE. Yes, ma'am.

Mrs. KENNELLY. I have about 5 minutes to get to the floor to vote, and I will be back as soon as possible.

You got that plane?

Ms. PLUMB. I do need to catch a plane. If you have any questions, I would be happy to answer them at some other time in writing.

Mrs. KENNELLY. I was a city councilwoman, and I think we are saying the same thing. When I lobbied this bill, I really worked on the housing angle, but to me that is just a part. The soul, and you used the word spiritual, the soul of this recommendation we have is to revitalize our communities to bring neighborhoods back into being.

As a fellow city councilwoman, do you agree with me on that, Ms. Plumb?

Ms. PLUMB. There is no question about it, and our community is living proof.

Mrs. KENNELLY. Thank you. I will be right back.

[Brief recess.]

Mrs. KENNELLY. Mr. Barksdale, you may continue.

Mr. BARKSDALE. Well, I was simply ending, ma'am, by saying that, and I will simply say that if the downtowns of America, whether they be large or small, are identified as being the hearts of our communities, the hearts of our nation, then we need to do everything that we possibly can to make sure that they are not only saved, but that they have become or reestablished as part of commerce.

The one thing that I think we in Main Street in downtown revitalization have learned concerning not only the preservation aspects, but the overall revitalization aspects is this. Downtowns were built for the making of money. That is why those buildings were constructed. And, if we are going to save and preserve those buildings not only for today's generations but for future generations, I think it is important that we understand that they have to continue to generate profits, and to do that we need to provide the incentives to make that happen.

That is what we are doing in Main Street, and that is what we are seeing happening in Kentucky. The projects that take place take place when the property owner realizes that it is going to generate a profit for him.

Yes, ma'am.

[The statement of Mr. Barksdale follows:]

STATEMENT OF SCOTT BARKSDALE, PROGRAM COORDINATOR, KENTUCKY MAIN STREET PROGRAM, KENTUCKY HERITAGE COUNCIL

I very much appreciate the opportunity to be part of this forum today. It is indeed a privilege and an honor to represent the Commonwealth of Kentucky's Heritage Council and its Main Street Program. Twenty-eight states in addition to Kentucky are also involved in the Main Street effort, and I will speak to some extent on their behalf as well.

The Kentucky Heritage Council serves as Kentucky's historic preservation office. It is responsible for preserving and protecting Kentucky's historic resources, for educating the public about the importance of preservation, and for providing technical assistance to citizens and local communities in preservation efforts.

The Main Street Program operates within the framework of the Heritage Council, seeking to prombte economic development and revitalization of central downtown commercial districts through historic preservation.

Main Street is a comprehensive, self-help program through which communities can address the issues and problems facing their downtown areas. The Main Street approach has been highly successful across the country because it incorporates a solid understanding of downtown issues and problems. The National Trust for Historic Preservation and its Main Street Center are now working with more than 500 communities in 29 states. Participating towns are encouraged to develop their local programs around the four basic points of the Main Street approach to downtown revitalization. The points are organization, promotion, design, and economic restructuring.

Organization includes not only developing and maintaining a single body to administer the local program, but also fostering a cooperative spirit among key players involved in the revitalization effort. Through this facet of the Main Street program, local government officials, merchants, property owners, development agencies, local lending institutions, civic groups and others coordinate their efforts to improve downtown.

Promotion involves projecting a positive image of downtown. Efforts include developing an image of a unified downtown, innovative retail promotions, and staging of special events. Promotion is an important way for downtown businesses to reach potential customers and tourists, and to foster community pride in the downtown.

Through **Design**, the physical appearance of downtown is improved. Activities conducted under this component include sensitive building and facade rehabilitation, maintenance and beautification of public spaces, appropriate signage, and attractive display of merchandise.

Economic Restructuring, the fourth and final component, involves a process of examining current economic and market forces affecting the downtown, and determining what types and mix of retail, professional services and housing will prosper in the area. Tools used in economic restructuring include market analysis; business assistance programs; upper-floor housing conversions; and business retention, expansion and recruitment.

Creation of local economic incentives and use of existing incentives to leverage reinvestment in the downtown is a key ingredient in the economic restructuring process. An attractive development package can be created by combining the Rehabilitation Tax Credit with other local incentives such as low-interest loan pools and property tax moratoriums.

We at the Kentucky Heritage Council have learned that we can only achieve our goal of preserving the historic resources of our downtowns and their architecture through a healthy economy in the downtown areas. Our efforts have to make economic sense. Downtowns were built for commerce, for the making of money. To justify their continued existence, we must provide a means for property owners and businesspeople to maintain a reasonable margin of profit.

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The Rehabilitation Tax Credit contributed greatly toward achieving this goal until it was inadvertently weakened by passage of the Tax Reform Act of 1986. I will share with you as an example the story of Bowling Green, a city of 42,000 in southwestern Kentucky.

In early 1988, the Kentucky Heritage Council, through a grant to the Kentucky Municipal League and the University of Kentucky, undertook a study of the economic benefits of historic preservation in Bowling Green. The results clearly demonstrate the significant positive impact which the Rehabilitation Tax Credit had on reinvestment in the community's downtown. The following are documented results from investment between 1980 through 1988, which was also the first eight years of the local Main Street program.

- **Nineteen (19)** rehabilitation projects utilized the Rehabilitation Tax Credit, with a total investment of **$3,981,000.**

- An additional **40 rehabilitation projects** and **ten new construction projects** resulted in an additional investment of **$14.8 million**. The renewed interest in downtown caused by the local Main Street Program and the Rehabilitation Tax Credits encouraged these additional investments.

- The total investment of more than $18 million produced **57 net new businesses** and **14 additional housing units.**

- The study surveyed developers who used the Rehabilitation Tax Credit to find out how important the credit was in making the projects feasible. **Ninety-two percent** of the developers said the tax credit was either an important or very important factor in their decision to carry out the projects.

- Renovation efforts increased tax receipts by **$734,000**. They created **232 jobs**, increased gross output by more than **$9 million**, and increased earnings by more than **$3 million.**

- Other benefits resulted from these projects as well, including an improved image for the downtown along with enhanced feelings of pride on the part of property owners, merchants and residents. The accompanying development of additional cultural activities and a greater sense of stability in the downtown are intangible benefits, but are important nevertheless.

This specific case study provides a window to view the tremendous impact the tax credit has had on one community and on Kentucky state-wide. It clearly documents the benefits of this specific federal program. It also acts as a mirror to reflect the sudden sharp decline in the use of the Rehabilitation Tax Credit following the 1986 Tax Reform Act.

In Bowling Green, only two projects have been undertaken since the 1986 Tax Reform Act went into effect. There may be several reasons for this decline, which may include confusion over the new legislation, the disincentives created relating to passive income and limitations on depreciation periods and maximum credit allowances. Some might argue that the decline is because most of the qualified buildings have been rehabilitated. All of these are valid arguments. However, I would respectfully submit that in my state alone, 28 other cities currently in the Kentucky Heritage Council's Main Street Program now do not have the same advantage that Bowling Green had because of the reductions and limitations imposed by the 1986 Tax Reform Act.

Going beyond the example of Bowling Green, 256 tax credit projects were undertaken in 18 Main Street cities between 1980 and 1988. These projects involved a total reinvestment of $81,225,248. Seventy-five percent of them took place prior to passage of the 1986 Tax Reform Act. That figure would have been closer to 90 percent had not the city of Covington, Kentucky, been able to offset the negative impact of the 1986 revisions with local incentives. Covington is the exception to the rule of decreased investment in the rehabilitation of historic properties. Low-interest loans, grants and deferred loans were made possible in Covington through funding from the Community Development Block Grant and Urban Development Block Grant programs.

The examples of Bowling Green and the Commonwealth of Kentucky overall reflect what has happened across the nation. A sudden and very apparent drop in Rehabilitation Tax Credit projects coincides with implementation of the 1986 revisions.

I will end my testimony with this simple and logical statement on the subject of downtown redevelopment. If the downtowns of America are the hearts of our communities, both large and small--if their history, architecture and heritage are not only worth saving, but worth re-establishing as part of the commerce of today--then we all have a responsibility to provide the incentives for it to happen. The responsibility lies with us as individuals, with the local communities, with the states, and with the nation. The Community Revitalization Tax Act of 1989 will provide downtowns with a substantial and proven incentive for leveraging redevelopment.

Mrs. KENNELLY. Thank you, Mr. Barksdale, for some excellent testimony. I really appreciate you appearing before us today. Thank you very much.

Mr. BARKSDALE. Thank you, ma'am, I appreciate it.

Mrs. KENNELLY. The next panel, Connecticut Historical Commission, John Shannahan, director, State historic preservation officer; Diane Dale, president, Anacostia Historical Society; National Housing and Rehabilitation Association, Frederick Copeman III, member, executive vice president, Boston Bay Capital, Boston, MA.

Mr. Copeman, I understand you are the one with the plane problem on this panel. Why don't you begin?

STATEMENT OF FREDERICK H. COPEMAN III, MEMBER, NATIONAL HOUSING AND REHABILITATION ASSOCIATION, EXECUTIVE VICE PRESIDENT, BOSTON BAY CAPITAL, INC., BOSTON, MA

Mr. COPEMAN. Thank you very much, and good afternoon, Madam Chairman.

My name, again for the record, is Frederick Copeman, and I am executive vice president of Boston Bay Capital in Boston.

Boston Bay Capital has been providing equity for rehabilitating historic property since 1978, and we are the largest remaining source of equity capital for historic restoration. I appear today both on behalf of Boston Bay Capital and for the National Housing and Rehabilitation Association.

Madam Chairman, prior to 1986, 95 percent of all the equity capital for historic restoration came from one source: limited partnerships that were structured within the confines of SEC regulation D, the so-called private placement transaction. Reg D provides a system for raising capital which allows the sponsor to avoid the time-consuming and expensive process of going through public registration.

There is, in essence, a tradeoff. In order to gain the benefit of regulation D, the sponsor has to agree to make offers of the investment to no more than 35 so-called unaccredited investors. An accredited investor for this purpose is an individual whose annual income exceeds $200,000.

By focusing on, in the alternative, accredited investors under the prior law, we gained three important things. First, we dealt with investors that had both the resources and the financial sophistication to understand the risk reward relationship inherent in historic restoration. Second, we kept transaction costs to a minimum. And third, we could typically raise the required capital for historic projects in 2 to 3 months.

This, in turn, did several important things for the restoration movement in this country as a whole. It allowed us to use a capital formation system that worked as well for the Main Street revitalization project in a small town as it did for the large glitzy projects in our major cities that some people have come to associate with historic rehabilitation.

Perhaps more importantly, it allowed development companies considering historic rehab, the confidence to know that at the end of the 18- to 24-month development track, which is common to historic restoration, that they could achieve a reimbursement of their

up-front costs and earn a development fee from an equity syndication.

This was a critical component in incenting developers to pursue, what I think many people will tell you, is the riskiest form or at least one of the riskiest forms of real estate development.

In summary, we had a perfect partnership, a tax credit which accomplished what it was supposed to do, and a capital formation system that worked efficiently for restoration projects of all types and sizes.

The 1986 Reform Act obviously had many, many consequences for historic restoration. We kept the rehab credit through the efforts of people like yourself, but we, in passing, in section 469, and particularly 469(i), established a provision which denies access to rehab credits to investors whose adjusted gross income exceed $200,000 a year.

And so, we have a kind of sinister confluence between the regulation D rules that I talked about a minute ago and 469(i).

What impact has this had on the capital formation process? First of all, the Reg D private placement that we came to rely on, Madam Chairman, is effectively dead. Of the few private placement transactions that have been attempted since the 1986 Reform Act, most have failed and, in fact, as a practical matter, one of the primary sources for historic projects for the public fund that we operate, are busted private placement deals.

Corporate investors are not investing in historic restoration. I am here to tell you that from personal experience. The chief financial officer of most corporations wants two things in an investment: (a) he wants to avoid risk; (b) he wants a highly reliable rate of return from his corporation's investment.

Those attributes are simply not present in historic rehabilitation. I can tell you that there are some corporations investing in low-income housing, and they can get those two attributes from low-income housing. They have low operating risks because of the existence or rental subsidies and subsidized mortgages, and they have reliable rates of return because of the structure of the low-income credit. But, it is simply not available in historic rehab projects.

So, what we have been left with as the only viable means for financing historic restoration are publicly registered partnerships, and there are at present in the country two companies that are operating public funds strictly for historic restoration.

Even though it is possible to raise capital in the format of a public fund, there are continuing tremendous disadvantages. It has cost my company $5 million to offer public funds since 1986 in filing fees, legal fees, printing costs, and most importantly the cost of building a national brokerage network to raise capital.

One of our greatest concerns is the tremendous slowdown in restoration activity in the development community. So, notwithstanding the fact that we have found a way against all odds to raise capital in the public partnership format, the number of projects that are coming to us as investment proposals has fallen at a remarkable rate.

Prior to the 1986 Reform Act, we could count on getting 200 to 300 investment proposals unsolicited in a year's time. If we get one to two a month, now, we count ourselves fortunate.

Finally, we are unable to invest in small projects because of the need for a public financier to achieve economies of scale, and because of the sophisticated financial reporting requirements that the SEC imposes on us.

We, therefore, support H.R. 796 because it would permit a limited reentry of the accredited investor into the equity market for restoration. And, it would help return the focus of the development community towards historic rehabilitation. In the absence of a reliable capital formation system, developers will simply continue pursuing other types of activity.

Now, will the proposed modifications of H.R. 796 be sufficient to attract new capital without also adjusting the passive loss rules? Our experience, quite clearly, says yes. Will, the new provisions allow wealthy investors to recreate the tax shelter abuses that we saw in the early 1980's?

Madam Chairman, it is our judgment that it will not. Congress has the perfect mechanisms in the alternative minimum tax and in the use of the general business credit rules to monitor and refine how credits are used by wealthy taxpayers.

The Community Revitalization Tax Act simply allows the capital formation process for historic rehabilitation to work at a reasonable level. Let us work together to rehab the credit and make it work again.

Thank you, Madam Chairman.

[The statement of Mr. Copeman follows:]

STATEMENT OF FREDERICK H. COPEMAN BEFORE
THE HOUSE WAYS AND MEANS SELECT REVENUE
MEASURES SUBCOMMITTEE

My name is Frederick H. Copeman and I am Executive Vice President of Boston Bay Capital, Inc. in Boston, Massachusetts. Boston Bay Capital is the largest source of equity capital in the United States for historic rehabilitation projects. During the past ten years we have raised over $150 million of equity capital to finance the restoration of 74 historic properties in 23 states around the country. My appearance today is on behalf of Boston Bay Capital, as well as the National Housing and Rehabilitation Association. NH&RA is an association of professionals involved in the development, ownership, operation and financing of multifamily housing which primarily serves lower-income Americans.

I will direct my remarks this afternoon to the capital formation process for historic rehabilitation projects with particular reference to the impact of the Tax Reform Act of 1986 on that process. Toward that end I believe it will be useful to examine the manner in which rehabilitation projects were financed prior to the 1986 Act. As I look back at the 57 properties we helped to finance prior to 1987, several patterns emerge:

1.) 40% of our projects were rehabilitated for housing uses, 35% for office space and the balance for hotels, retail centers and mixed use buildings.

2.) The average capitalization for these projects was approximately $13,500,000 of which typically 30% came from investor equity and the balance from conventional, market rate financing.

3.) In every case, the mechanism for raising investor equity was a limited partnership organized as a so-called "Reg. D" private placement securities transaction. The average investor committed $135,000 of capital paid in over a 3-4 year period.

This system of raising equity capital was not unique to my company, indeed it was the mechanism used for raising 95% of all the equity capital directed towards restoration of historic buildings in this country. The private placement transaction was the preferred technique for the following reasons:

1.) Efficiency - Offering large investment units to a small group of high income investors allowed the capital formation process to work quickly and with fairly low transaction costs.

2.) Reg. D. Compliance - By complying with SEC Regulation "D", the sponsors of an historic rehab offering were able to avoid the lengthy and extremely costly process of registering their transactions with the Securities and Exchange Commission. Regulation D allows a sponsor to offer securities to an unlimited number of accredited investors and no more than 35 unaccredited investors by registering with one or more state securities commissions. For this purpose, an "accredited investor" is an individual with annual income in excess of $200,000 and/or a net worth in excess of $1,000,000.

3.) Timeliness - A typical private placement offering could, under the old rules, be placed in 30-60 days with a high degree of assurance. This allowed a developer to embark on the 18-24 month development track normal for historic restoration without having to worry about whether he could successfully raise sufficient capital to reimburse his "up-front" costs and earn his development fee.

This system of raising capital from investors was highly efficient. More importantly, however, it worked as well for the small "Main Street" revitalization projects as it did for the larger projects many people have come to associate with historic rehabilitation. Indeed, the National Park Service statistics demonstrate amply that the vast majority of restoration projects undertaken between 1981 and 1986 were fairly modest in size and generally were located in our smaller cities and towns.

Were rehab tax credits used to create abusive tax shelters? Sometimes. But the same can be said any time the tax code is used to stimulate investment. While investor behavior was largely motivated by the availability of rehabilitation tax credits, nonetheless it was the public purpose of revitalizing part of a main street or reclaiming an abandoned warehouse for housing which was the underlying motivation for most restoration transactions. Thus, despite a small number of abuses, under prior law we had an efficient partnership: a tax credit which accomplished what it was supposed to do, and a capital formation system which worked efficiently for restoration projects of all types and sizes.

IMPACT OF THE TAX REFORM ACT OF 1986

Obviously, the 1986 Act had manifold consequences for historic restoration projects - at-risk rules, lengthening of depreciation periods, tightening of the alternative minimum tax rules, etc. However, certain provisions of Section 469 have had a particularly devastating impact on the capital formation process for historic rehabilitation.

Section 469 generally provides that losses and credits generated by an investment in an historic rehabilitation or other real estate project cannot be used to offset the tax on regular or "active" income. An important exception, found at Section 469(i), provides that investors in low income housing or historic rehabilitation projects may use credits to shelter the tax on up to $25,000 of active income. However, investors with incomes in excess of $200,000 are denied access to the exception of 469(i). This means, in effect, that the people who can make most efficient use of credits, the people who can afford to understand the complexities of this investment, the people who in fact bought all the older historic credit properties, now cannot buy them.

This has been terrible for historic restoration:

1.) Private Placements Are Dead - The confluence of Section 469(i) and Regulation D creates horrific results: accredited investors, are in almost every case foreclosed from the ability to use low income housing or rehabilitation tax credits, they have taken their capital elsewhere. Since the sponsor can offer a private placement investment to only 35 investors, the most a private placement can expect to raise under today's rules is about $1,000,000 net of transaction costs. We can personally attest to the death of the private placement as a technique for raising restoration equity. Half of the historic rehab projects in which our public fund invested during 1988 were "busted" private placements.

2.) Corporate Investors - Corporate investors, with rare exceptions, will not invest in historic rehabilitation projects. The Chief Financial Officer in a typical corporation is highly averse to risk and demands a very reliable return on capital. Low income housing tax credit transactions are a much better match for these goals. Even here, few corporate deals have been done. First, the ten year stream of tax credits and losses will provide most of the economic return and are highly susceptible to calculation within a few basis points. Second, the existence of rental subsidies and/or below market financing common to LITC transactions has the effect of dramatically reducing operating risk. Accordingly, the small amount of corporate capital traditionally directed at historic restoration has now been drawn towards low income housing.

3.) Public Funds - My company had essentially two options after the 1986 Reform Act - go into another business and abandon the expertise we had developed in historic restoration or start a public fund. In order to offer a partnership investment as a publicly registered security, the following steps were required:

- You must be prepared to spend about $1,000,000 per offering for legal fees, filing fees, printing and other out-of-pocket costs;

- You must assemble a national syndicate of brokerage firms that is capable of marketing at least $20,000,000 of partnership interests in $1,000 units (again at considerable cost);

- You must build a large administrative staff to evaluate properties, account for partnership funds and handle investor and broker inquiries; and

- For the life of the investment, you must file with the SEC quarterly 10-Q's and annual 10-K's, which are quite costly to prepare.

In the wake of tax reform, a crisis in the S&L industry and bad news in many real estate markets, this was a daunting task.

4.) Prospects for the Future - Notwithstanding these difficulties, we have been successful in raising capital for historic rehabilitation in this format. Our first public offering in 1987 raised $10.5 million, in 1988 we raised just under $29 million and this year we expect to raise between $50 and $60 million. However, we continue to be negatively impacted by the Tax Reform Act in several ways:

- We cannot market to our traditional investor because of their inability to utilize rehabilitation credits. Yet these are the very individuals who have the means and the financial sophistication to properly assess the risk/reward ratio inherent in historic restoration;

- Prior to 1986, we could rely on receiving 200-300 unsolicited investment proposals a year from developers undertaking historic restoration projects. In the current environment we count ourselves fortunate to receive one per month. Given all the other risks a developer of historic properties has to take, the absence of equity capital has proven to be the last nail in the coffin;

- In addition, the extension of the at-risk rules and, in particular, the so called "80/20" test of Section 46(c)(8), has made debt financing for rehabilitation projects extraordinarily difficult. Since the statutory language was not drafted with historic restoration in mind, tremendous uncertainty exists with respect to its practical application to rehabs. Our projects tend to be financed 35% with investor

equity and 65% with conventional debt financing. On the surface, it should be easy for us to comply with Sec. 46(c)(8). In the absence of technical guidance, however, we have no assurance of such compliance. The problem is particularly serious in smaller projects involving municipal financing or other forms of public support.

H.R. 796

The Community Revitalization Tax Act of 1989 would, if enacted, address some of the unintended damage to the capital formation process occasioned by the 1986 Reform Act:

- It would permit a limited re-entry of the accredited investor into the equity market for low income housing and historic rehabilitation projects. This would allow some projects to be funded through the mechanism of the private placement transaction.

- It would help return the focus of the development community towards historic rehabilitation. In the absence of a reliable system for capital formation, developers will continue to focus on other kinds of development and the deep decline in restoration activity we have already seen since 1986 will not improve.

Will the proposed modifications to the use of the credits be sufficient to attract new capital to historic rehabilitation even without allowing use of passive losses? Our experience says Yes, credits are sufficient by themselves. Investors will commit capital to restoration projects that combine some early tax advantages with sound underlying investment principles. Our experience shows that we can adaptively reuse historic properties for residential and commercial uses at prices that make fundamental economic sense. However, under existing rules, public funds for historic restoration can only attract about 10% of the capital that can be raised for low income housing. In light of the dramatic difference in "tax shelter power" between the two programs, the inability of the rehabilitation industry to access accredited investors has taken a far heavier toll on the rehabilitation industry than on the low income housing industry.

Some have advanced the proposition that the enactment of H.R. 796 will recreate the days of tax shelter abuse by wealthy investors. This conclusion emanates from an imperfect understanding of the proposed legislation. H.R. 796 does not:

- Allow investors to use passive losses;
- Bypass or mitigate the alternative minimum tax provisions;
- Change the at-risk or depreciation rules; or
- Allow for the interest accrual or over-valuation abuses common to pre-Reform Act tax shelters.

The Community Revitalization Tax Act simply allows the capital formation process for historic rehabilitation to work again. It does not require a new class of tax expenditure or a departure from the spirit of the passive loss rules as they were intended to work.

The rehabilitation tax credit is the most efficient tax expenditure in the Code. By virtually unanimous agreement it has done a remarkable job in revitalizing cities and main streets throughout America. Let's "rehab" the credit and make it work again.

Mrs. KENNELLY. Thank you, sir, and I know you are in a hurry.

Being in real estate, have you ever seen this kind of dramatic falloff in another area or in another situation as this one?

Mr. COPEMAN. We have never seen, in our experience, anything like it.

Again, we are involved in primarily historic restoration. We are also involved in financing low-income housing creation. But the dropoff in investment proposals to us is so tremendous, that we look out at this kind of chart and wonder where the thing drops off, where it finds a bottom.

Mrs. KENNELLY. And you see to the passive activity rules as being the reason for this drop off?

Mr. COPEMAN. Prior to 1986, Madam Chairman, we had approximately 2,000 individual investors that we could look to for investing in our projects. We have lost the entire 2,000 client base. None of those investors will invest under these rules, and it is very simple to understand why.

We are a nation that is used to investing and want immediate gratification for our capital. We want a rate of return right away. We are not patient investors.

If a wealthy individual is offered the opportunity to invest in historic restoration and does not have the up-front tax advantages, that individual is looking at a very long horizon before they get the first penny on their dollar sent back to them

Very simply, our experience shows that that is not happening.

Mrs. KENNELLY. Thank you, sir, very much for your testimony.

Mr. COPEMAN. Thank you very much.

Mrs. KENNELLY. Welcome, Mr. Shannahan. I think it is wonderful Connecticut was one of the first States to really show how this problem could work, and now we are also one of the prime examples of how it is not working.

So we are doing our part. Thank you for coming down, and we would like to hear your testimony now.

STATEMENT OF JOHN W. SHANNAHAN, STATE HISTORIC PRESERVATION OFFICER FOR CONNECTICUT AND DIRECTOR OF THE CONNECTICUT HISTORICAL COMMISSION

Mr. SHANNAHAN. I appreciate the opportunity to come down today, Madam Chairman, and I would like to say on behalf of all of the preservation community in Connecticut: We appreciate the efforts you have been putting into preserving this tax credit.

Mrs. KENNELLY. You have taught me all I know.

Mr. SHANNAHAN. You have been working to preserve this tax credit 4 years.

In summary—you have a copy of my testimony——

Mrs. KENNELLY. Yes, it will all be placed in the record.

Mr. SHANNAHAN [continuing]. I would like to summarize the highlights of it.

For the record, my name is John W. Shannahan, and I am the State historic preservation officer in Connecticut and director of the Connecticut Historical Commission.

After more than 10 years of reviewing projects in Connecticut, we feel we have extensive experience in monitoring the benefits of

this program. In Connecticut, we have reviewed over 550 projects in that 10 year period, totaling an investment of more than $450 million.

The years of highest activity were clearly in the period of calendar years 1982-85. In that period nationwide, Connecticut ranked—and we heard earlier—the Director of the National Park Service gave similar comments—11th in terms of the approved number of projects and 12th in the amount of investment, and in your city of Hartford, which was one of the top 10 cities in the country in terms of the investment that took place in historic preservation.

I know you have toured many of those, rehabilitation projects that have brought back neighborhoods and created an enormous number of units of housing for the city of Hartford.

A substantial majority—more than two-thirds—of the projects in these same calendar years were residential, entailing rehabilitation of existing housing stock or creation of new residential units through adaptive use of schools, industrial buildings, or the conversion of upper-floor commercial space in mixed-use buildings.

In all, these projects involved 3,200 units of housing, and approximately half of these units were new housing. All told, more than 7,000 housing units—have been rehabilitated just in the State of Connecticut.

And what has happened since the passage of the Tax Reform Act of 1986? Even prior to the passage of this legislation in calendar 1986, the number of historic rehabilitation projects had declined by one-third from the previous year.

In calendar years 1987 and 1988, however, the figure dropped dramatically to approximately two-fifths of the number of projects in 1986, an already low figure.

In fact, the 1987 and 1988 figures are the lowest in the history of the preservation tax program in Connecticut. We are talking about going from 100 projects that we were processing in calendar 1983 to just 17 projects that we processed in calendar 1988.

Moreover, the nature of the program has changed. In both absolute and relative terms, there has been a decline in residential projects. Fewer than half the projects reviewed in these 2 years were residential. Few involved the rehabilitation of existing multifamily housing, and more of the new units being created are condominiums rather than rental property.

The decline in interest in the Preservation Tax Incentive Program is not the result of the fewer buildings or that we have done it all. On the contrary, we have more than 30,000 buildings listed on the National Register in Connecticut alone, and many of these buildings are income-producing, in use, and are located in urban residential neighborhoods.

These buildings will require substantial capital investment to continue in productive use, nor has the need for affordable housing decreased. What we have seen in Connecticut is that a program which created rental housing added to the tax base, created jobs, and benefitted community revitalization efforts—is no longer an effective program to realize these goals.

And it is interesting, reflecting as I was flying down here this morning thinking about how in the last 3 years the number of litigation matters that our commission has been involved with, with

developers who want to demolish historic buildings, has increased dramatically in these last 3 years, and one only has to wonder if we had the pre-1986 tax law, would we have been able to encourage these developers to rehabilitate these buildings rather than demolish.

I feel that your proposed bill is the direction we need to move in at this time, and we urge for you and the members of your committee to move forward with this, and I appreciate the opportunity to be here today.

Thank you.

[The statement of Mr. Shannahan follows:]

Statement for the Subcommittee on Select Revenue Measures
U.S. House of Representatives
Committee on Ways and Means
Washington, D.C.
June 6, 1989

Submitted by: John W. Shannahan
State Historic Preservation Officer
59 South Prospect Street
Hartford, Connecticut

Mr. Chairman and members of the Subcommittee:

My name is John W. Shannahan. I am the State Historic Preservation Officer for Connecticut and Director of the Connecticut Historical Commission. I appreciate the opportunity to explain to this committee the nature of the Preservation Tax Incentives Program in Connecticut from the perspective of more than ten years of review of historic rehabilitation projects.

The Preservation Tax Incentives Program has been an active one in Connecticut. Since 1977, after passage of the Tax Reform Act of 1976, the first legislation to provide tax incentives for rehabilitation, the State Historic Preservation Office has reviewed over 550 projects, representing a total investment of $450 million. In particular, since January 1, 1982, the effective date of the Economic Recovery Tax Act of 1981, through December 31, 1986, our office has submitted to the National Park Service approximately 370 projects at a total of $310 million.

The years of highest activity were in calendar 1982-1985. Per annum, the average number of projects was 80, with rehabilitation costs totaling $60 million. In that period, nationwide, Connecticut ranked 11th in terms of approved numbers of projects and 12th in the amount of investment. The City of Hartford was ranked among the top 10 cities nationwide with 140 projects valued at $55 million.

A substantial majority -- more than two-thirds -- of the projects in these same calendar years were residential, entailing either rehabilitation of existing housing stock or creation of new residential units through adaptive use of schools and industrial buildings or conversion of upper-floor commercial space in mixed-use buildings. In all, these projects involved 3200 units of housing. Approximately half were new units of housing. Although school and mill conversion projects represented a significant percentage of the total dollars invested in historic rehabilitation projects, they constituted a far smaller percentage of the total number of projects. The greater preponderance of projects involved the rehabilitation of abandoned, vandalized or sub-standard multi-family buildings to create affordable modern housing units. The vast majority of these buildings were located in urban residential neighborhoods, principally in Hartford, New Haven, and Norwich. These projects contributed to neighborhood stabilization.

What has happened since passage of the Tax Reform Act of 1986? Even prior to passage of this legislation, in calendar 1986 the number of historic rehabilitations declined by 1/3 from the previous year. This is understandable given the then uncertainty about retention of the preservation tax incentives in the new tax code. In calendar years 1987 and 1988, however, the figures drop dramatically to approximately 2/5 the number

of projects in 1986, an already low figure. In fact, the 1987 and 1988 figures are the lowest in the history of the Preservation Tax Incentives Program in Connecticut. There has, as well, been a commensurate decrease in investment. The 1987 and 1988 figures are half the pre-1986 average. These statistics are consistent with those nationwide. Moreover, the nature of the program has changed. In both absolute and relative terms, there has been a decline in residential projects. Fewer than half the projects reviewed in these two years were residential. Few involve the rehabilitation of existing multi-family housing. In general, these projects utilize the low-income housing credit in combination with the historic tax credit. More of the new units being created are condominiums rather than rental.

The decline in interest in the Preservation Tax Incentives Program does not mean that today there are few historic buildings to rehabilitate. Connecticut has 30,000 buildings listed on the National Register of Historic Places. Many of these buildings are income-producing in use and are located in urban residential neighborhoods. As is the case in much of the Northeast, these buildings predominantly date from the late 19th through the early decades of the 20th century and will require substantial capital investment to continue in productive use. Nor has the need for affordable housing decreased. What we have seen in Connecticut is that a program which created rental housing, added to the tax base, created jobs and benefitted community revitalization efforts is no longer an effective program to realize these goals. For these reasons, we urge the Subcommittee to give favorable endorsement to the Community Revitalization Tax Act of 1989 and we look forward to its eventual adoption by Congress.

Mrs. KENNELLY. Thank you, sir, very much.
Ms. Dale.

STATEMENT OF DIANNE DALE, PRESIDENT, ANACOSTIA HISTORICAL SOCIETY, WASHINGTON, DC

Ms. DALE. Thank you. Good afternoon.
Mrs. KENNELLY. Good afternoon.
Ms. DALE. For the record, I am Dianne Dale, president of the Anacostia Historical Society. I appreciate the opportunity to testify in favor of the restoration of the rehabilitation tax credit.

The history of the Anacostia community can be documented—dates back to 1608 when John Smith sailed up the Anacostia River.

An 1859 map of the community east of the river shows the new community of Uniontown, the U.S. Lunatic Asylum, which is what St. Elizabeths was called at that time, and there was a parcel of land—375 acres that fell between the two areas that was owned by James Barry. It was a farm that was owned by James Barry who was an erstwhile city official.

Anacostia is the first suburb of Washington, DC, and the Uniontown community was established to entice blue collar workers from the Navy Yard to come across the river for clean air, fresh water, and country living.

In 1967, the Freedmen's Bureau, under the directorship of Commissioner Oliver Otis Howard, purchased this 375 acres of attractive land, and it was resold to emancipated African-Americans. It was subdivided into one and two acre lots and was, again, resold to African Americans after emancipation.

The sale of the lots was—the money from the sale of the lots was used to establish Howard University in that same year, 1867. The school, of course, was named after General Howard, who was a union war general.

This area was called Barry's Farm. My great grandfather came to Barry's Farm in 1892. He brought his wife and four children, at that time. Three more were born in Anacostia. That was 22 years after Frederick Douglass purchased the mansion from the developer of Uniontown, Mr. John Van Hook.

Mrs. Ella Pearis still lives in the home that her grandfather built in Barry's Farm. He built it in 1874.

There are five churches in the community that are over 100 years old. One of them, Bethlehem Baptist Church, was built by one of the first settlers, John Anderson, whose granddaughter and great grandson still live in the area.

His grandson, Stanley Anderson, was one of the first appointed city council members. He was appointed by President Lyndon Johnson.

Uniontown, today, is known as Old Anacostia. It received historic designation in 1978.

Barry's Farm has no historic designation, but it is as historically significant, we feel, as is Old Anacostia, and played a vital and significant role in the history of blacks in America.

This summer, the Anacostia Historical Society will be participating in two projects, one of which is an archaeological survey of

both Uniontown and Barry's Farm, and the other is an oral history from persons who are familiar with the history of both areas.

We need, in addition to the relics from the past and the oral history—the memories—we need some tangible visible evidence to show the children—show our children, the children of the future, what was there. I think with the restoration of the rehabilitation tax credit, it would give some incentive to developers to help us preserve what is left.

Many of the structures—my grandfather's house is gone. It was torn down maybe 10 years ago, but it was habitable or could have been rehabilitated had there been the incentive to do so. Many houses of that same era are gone for the same reason. They were just left to deteriorate, and the city said, "Tear them down or you will be fined," and so, they were torn down, because there was no incentive, again, to keep them intact.

History is still being made in the community. We have at Frederick Douglass Junior High School the first junior high school rowing team in the city. They competed in the—they did not compete, but they rowed in the Mayor's Cup Regatta last weekend at Riverfest.

We have the only neighborhood museum that is run by the Smithsonian Institution. We have a group of students at Kramer Junior High School who are involved in the Kramer Anacostia planning project. The principal wanted the children in the community to understand the community, to embrace the community, to have a feeling for the history that is there, and so created this Kramer Anacostia planning project.

These children are becoming acquainted with what planning issues involve how to plan for their communities, what they should know in order to do this. They learn the history of the community. Of course, you have to in order to know where you are going.

Also at Kramer, there is a house in the school. The children built—there were 15 students who started building a house in November in woodshop and will complete it this month.

It is a fully equipped one-bedroom house with a fully equipped kitchen, bathroom. It is wired. It has plumbing. It can be lived in. It is a permanent structure in the woodshop. It has a cinder block foundation, insulation, wood siding, everything, and again, the principal wanted the children to understand what it takes to keep a house, and these kids this summer will work in the community helping seniors to do rehabilitation work on their homes.

All of these things are important to a neighborhood. All of these things are important to persons who have lived in the community for a long time and have an emotional stake in the area, and the rehabilitation tax credit, I think, would help communities such as ours that have seen a gradual decline over the years. It would allow us to begin to see the community in a different light.

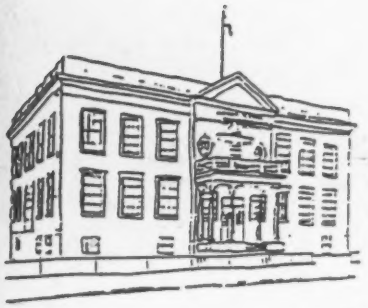
The historical society, particularly, is trying to provide projects and mechanisms by which we can change the image of the community, so that the children will see a future there and will want to stay there—will understand the rich history, the heritage that the community has, and we will see that they have a stake in it.

And if we can take the boards off of the buildings and put roofs back on and just generally provide a community-type atmosphere with stable homeowners and residents, then we will be well on our

way to bringing the community back to the thriving, close-knit area that it was when my great grandfather first came.

I think the tax credit would be a valuable tool and inducement for developers to help us accomplish this, and I appreciate this opportunity, once again, and I, again, urge the restoration of the rehabilitation tax credit.

[The statement of Ms. Dale follows:]



ANACOSTIA HISTORICAL SOCIETY

TESTIMONY OF DIANNE DALE
PRESIDENT OF ANACOSTIA HISTORICAL SOCIETY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
HOUSE OF REPRESENTATIVES
JUNE 6, 1989

Chairman Rangel and Members of the Subcommittee:

I am Dianne Dale, President of the Anacostia Historical Society. I am pleased to testify in favor of restoration of the rehabilitation tax credit. I recognize and applaud the efforts of the committee in maintaining a commitment to preservation activities which help keep neighborhoods intact.

An 1859 map of the area east of the Anacostia River shows the new community of Uniontown, the U.S. Lunatic Asylum (as St. Elizabeths Hospital was called then) and between the two, 375 acres of farmland owned by James Barry.

Uniontown was developed in 1854 as the city's first suburb, attracting blue collar workers across the river to country living, clean water and fresh air. In 1867 the Freedmen's Bureau, under the direction of Commissioner Oliver Otis Howard purchased Barry's Farm and subdivided it into one and two acre lots, homesteads for African Americans after emancipation.

The sale of the lots was used to establish Howard University. The area was called Barry's Farm. My great-grandfather brought his wife and four children to Barry's Farm in 1892, twenty-two years after Frederick Douglass purchased the mansion of Uniontown developer John Van Hook.

John Henry Dale, Sr. built a home for his growing family--three more children were born in Anacostia--and lived in Barry's Farm among others who had settled east of the river to start a new life. His house is gone now, but others remain that are of the era when the community was strong and vital.

Mrs. Ella Pearis still lives in the home built by her grandfather in 1874. There are five churches that are over 100 years old. One of them, Bethlehem Baptist Church was built by one of the earliest settlers John Anderson. John Anderson's descendants, a granddaughter and a great-grandson, live near the old homestead. Anderson's grandson is Stanley Anderson, one of the first District of Columbia City Council members, appointed by President Lyndon B. Johnson.

Uniontown is know today as the Old Anacostia Historic District, receiving landmark status in 1978. Barry's Farm has no such designation, although it is nearly as old and played a vital role in the history of this country and particularly of African Americans.

This summer, the Anacostia Historical Society will be involved in two projects to capture some of the history that has been lost. In connection with the Heritage and Cultural Education Program sponsored by the United Planning Organization, an archaeological survey will be conducted in the communities of Uniontown and Barry's Farm with excavations beginning in June. Oral history interviews will be collected to augment the dig. This research should lead us to placement of plaques and historical markers identifying areas we revere.

In addition to photographs and memories, we need tangible visible evidence to show our children what has gone on before. A third project of the Anacostia Historical Society is The Blooming Campaign through which we plan to restore to the area indigenous flowering herbs, shrubs and trees.

History is still being made in Anacostia. We have the only neighborhood museum, the Anacostia Museum, run by the Smithsonian Institution. Frederick Douglass Junior High School has the distinction of being the only junior high school in the city with a rowing team. Douglass Crew participated last weekend in their first event at the Mayor's Cup Regatta on the Georgetown waterfront at Riverfest.

Twenty-five students at Kramer Junior High School are members of the Kramer Anacostia Planning Project (KAPP). KAPP was organized to acquaint the students with the urban and community planning process, particularly as it relates to their neighborhoods. They learn of the history of the community in the process. In doing so they are able to plan, as future residents, how their neighborhoods should be developed.

Another project, Kramer World of Construction (KWOC), involves 15 boys and girls who began construction of a house in wood shop in November 1988. They will complete construction of the fully-equipped one-bedroom house in June 1989. The house was built from the ground up using building trades learned by the students and is now a permanent fixture in the classroom. It has a functional kitchen and bathroom and is covered in wood siding -- all done in-house.

Many projects such as these are being done to change the image of Anacostia, seen by many as an undesirable place to be. But for those who are familiar with the community of our forbearers, there is a vision of hope that projects pride and prosperity. This hope infects others who live in Anacostia and encourages a spirit of purpose and community well-being.

Restoration of the rehabilitation tax credit would enable communities like Barry's Farm to have a reasonable chance at preservation and recognition of it historical import even though many of the structures built by the first settlers are now gone. The tax credit would give incentives, to those with the means to do so, to restore houses sitting vacant and boarded. This would provide new opportunities for growth and development while maintaining the integrity of the community. We would not have to rely on hearsay and pictures but would have a visible link with yesterday.

The tax credit is a valuable tool for getting renovation dollars into the community. Neighborhoods crumbling and neglected would be revitalized and stabilized. Housing long unused would be returned to the pool. Communities rich with history buried beneath years of decline like the Barry's Farm area and that of Uniontown would begin to take on the character of those communities anchored by stable family units and homeowners. The tax credit would be a major inducement for private developers to turn communities like ours around.

Again, I urge restoration of the rehabilitation tax credit. The benefit would not only be to prospective residents, but to those whose roots and interests in the community go back to its earliest origins.

Mrs. KENNELLY. Thank you, Ms. Dale. Some very excellent testimony, and I appreciate your coming here today.

Ms. DALE. Thank you.

Mrs. KENNELLY. Mr. Shannahan, obviously we all know that the purpose of the passive loss rules, enacted as part of the 1986 Tax Reform Act, was to end tax avoidance and to help ensure that projects were done for the economic reality and not just to shelter dollars.

Having lived through what has happened, can you suggest any other ways, other than the way I am suggesting in H.R 796, to assist those that want to be in the rehabilitation business? Or do you think H.R. 796 is the avenue that is open to us to help and that is it?

Mr. SHANNAHAN. I think if we look at the projects that are not being done today—so many of the previous speakers talked about what is not happening, and we tracked the projects that went through our office from 1976 till the end of 1985, and that the typical project was in the range of about $750,000, and today in the last 2 years, we have seen that the typical project probably averaging $2 million, and in fact, many of them are much larger than that—$15 million and up.

And so it is that midrange project that was so instrumental in doing so much of the housing that we saw in Connecticut, and in my conversations with developers and people that were dealing with this before, they keep pointing to that passive loss rule.

Now, I am not a developer, and I am not an investor, but that is what they keep telling us is turning them off from investing in these projects and the ability to syndicate these projects.

We heard Mr. Copeman talk about how he makes a project happen. Well, there are only a couple of Mr. Copemans around this country, and I think that the typical developer just is not equipped to deal with the kind of investment structuring that he is able to put together, and so, we have turned off the average developer. They are looking for a project that can happen and not through this type of financing.

Mrs. KENNELLY. I was going to ask Mr. Copeman a question, and I did not get a chance to. We saw a little drop off in rehabilitation projects, prior to the 1986 Tax Reform Act. I wonder if you could explain any reason for that, or do you think it was just regular, normal economic activity?

Mr. SHANNAHAN. Well, as I recall, I believe that the Treasury report first came out in late 1985 which was talking about eliminating all tax credits, and certainly, anyone that was thinking about getting into this work probably was concerned that there would not be a tax credit and began to shift gears as early as that—1985.

Mrs. KENNELLY. The word gets around——

Mr. SHANNAHAN. Yes, it does.

Mrs. KENNELLY [continuing]. Rather quickly.

Mr. SHANNAHAN. And this is what concerns me, that these few developers that are still working in Connecticut that are trying to piggyback the low income housing tax credit with the historic rehabilitation tax credit.

They are concerned, because that credit is due to expire this year, and in trying to package these deals together, they just do not know whether they are going to be in business come the end of the year or not, and I know there is a great deal of urgency about trying to address that, because that is an important component to making these financing packages work.

Mrs. KENNELLY. So now is the time where we could be even, as you said, not in business.

Mr. SHANNAHAN. Definitely.

There are a lot of projects that will not happen, because of a concern of a lack of action for a new tax bill, I am sure.

Mrs. KENNELLY. Thank you both for excellent testimony, and I appreciate your being with us today. Thank you very much.

Mr. SHANNAHAN. I appreciate it, thank you.

Ms. DALE. Thank you.

Mrs. KENNELLY. The next panel, City Lands Corp., Sara Lindholm, president; Great Inns of America, Inc., Annapolis, MD, William E. Gilbert, president; Vulcan Development and Management Corp., Albany, NY, Mark J. Simmons, president; and the National Association of Home Builders, Martin Azola, member, National Remodelers Council of NAHB, president.

I think we will start at this end. Ms. Lindholm, would you begin?

STATEMENT OF SARA JEAN LINDHOLM, PRESIDENT, CITY LANDS CORP., CHICAGO, IL

Ms. LINDHOLM. Thank you. Madam Chairman, my name is Sara Lindholm. I have developed real estate on the low and moderate income black community on the South Side of Chicago.

Mrs. KENNELLY. Excuse me one moment, Ms. Lindholm. I have an ear problem this week. So if you could help me out and really speak into the mike, it would——

Ms. LINDHOLM. Here? Can you hear me now?

Mrs. KENNELLY. Yes, good.

Ms. LINDHOLM. I have developed real estate on the South Side of Chicago in a black low and moderate income neighborhood for the last 10 years. I love my job. I would not do anything else.

I am here to speak about the critical role that the rehab tax credit has played in the revitalization of this neighborhood, and to speak strongly in favor of H.R. 796.

My company, City Lands Corp., is the for-profit real estate development affiliate of the South Shore Bank of Chicago. In 1973, when the bank began its lending activities in South Shore, the community had just completed racial transition, from white to black, and was shunned by lenders and investors alike. Most of the area's rental stock was owned by absentee landlords who were milking the last cent of value from their buildings.

Today, the real estate market in South Shore is once again active and healthy; and a strong cadre of small-scale community-based real estate developers has emerged. These developers do not know anything about tax credits. They rehabilitate property with private loans from the bank, unsubsidized financing, and put in a lot of sweat equity into their projects, creating jobs and wealth locally

while producing decent and affordable housing for community residents.

Altogether, the bank has financed over 5,000 units of rehab, and is currently lending $12 to $15 million a year for this purpose. So what has been the role of tax credits?

The bank learned early on that the mere availability of credit does not initiate a demand for credit in a community that is on the skids. Catalytic developments had to be put into place in strategic locations to prime the pump; and this has been my company's role.

Over the past 10 years, we have developed five such projects, ranging in size from 63 to 446 units, choosing the largest and most deteriorated and difficult properties. The equity requirement for these projects ranged from $800,000 to over $5 million. Not a single dollar of it could have been raised without Federal income tax incentives.

Originally, we used section 167(k). And now we use both the low-income and rehabilitation tax credits. In particular, we have found the rehabilitation tax credit useful, where our objective has been to create a mixed-income development in which 30 to 40 percent of the units are rented to low-income tenants, and the rest are made available at affordable rents to moderate-income families. We have done two of these developments, totalling 277 units.

One of them, Jeffery Highlands, was right in the middle of development when the tax reform struck. This project lies a stone throw from the bank's offices and at the community's major intersection, in the most densely built-up block of South Shore.

In the late 1920's, six large residential elevator buildings, 450 units, were constructed in a half-block area. These properties declined extremely rapidly after racial transition in the 1960's; and by the early 1980's, they were notorious in the community. The largest property was abandoned and severely vandalized, and vacancy rates in the others were around 20 to 25 percent. Drug traffic and prostitution were widespread throughout the buildings.

In our judgment, these properties were not suited to development as low-income developments, so we sponsored a National Register nomination for the entire half-block area, and moved to secure as many buildings as we could at one time.

The resulting 150-unit project required a very complicated layering of financing and equity; and it looked like we needed an equity of approximately $1 to $1.5 million. The project took four years from beginning to end.

In 1986, 2 years into the deal, tax reform caused our original development partners to abandon the project. They were certain that we would not be able to raise the equity.

We proceeded to take it to closing alone, using our own funds, because of the importance of the project to our development agenda. In doing so, we placed the whole company at risk. Failure to syndicate the project before the units were placed in service would have permanently paralyzed our development capacity.

Over the next 9 months, the awful significance of the passive loss restrictions was brought home to us. Jeffery Highlands proved very unattractive to the national low-income equity pools. It was a market-rate deal in a distressed section of a low and moderate-

income black neighborhood. And to an outsider, this project appeared fraught with risk.

We had faced problems like this before; but prior to 1986, we had been able to overcome this problem by syndicating equity locally, without brokers, to individuals familiar with our track record. For example, in 1985, we had raised over $900,000 from 20 individuals for a similar historic mixed-income project. But now, the passive loss restrictions effectively close this avenue to us.

Finally, we induced the Chicago Equity Fund, one of those rare corporate investors, a locally based investment partnership of socially responsible corporations, to alter some of their standard investment criteria and purchase an 80 percent interest.

The closing took place 24 hours before the first units were scheduled to be placed in service. Fortunately, the project has been an outstanding success, both in terms of rent-up and development impact.

As soon as the Highland project was announced, redevelopment of the other three properties was undertaken by two other developers; and it appears that they are going to be successful in developing them.

Thanks to the rehab tax credit, the Jeffery-Cyril area is transformed from a dangerous and blighted eyesore to a source of pride and a development anchor.

We are moving on to replicate this process again and again in other urban neighborhoods. The South Shore Bank recently expanded its operations to another large minority community on Chicago's West Side, called Austin. This area is even farther down the disinvestment slide than South Shore was 15 years ago.

We are being requested to develop an average of 200 units a year for the next 3 years, to help prime the pump in Austin. But we cannot rely on the national equity market for investment in any but the most secure section 8 subsidized deals in this neighborhood. We will not be successful unless the usefulness of the rehabilitation and low-income tax credits is liberated by amending or eliminating the restrictions of the passive loss on our operations.

So I appeal to you to act favorably on H.R. 796, to enable us to continue to use these credits flexibly and powerfully in those neighborhoods that need them the most.

Thank you.

[The statement of Sara Lindholm follows:]

SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

PUBLIC HEARING ON REHABILITATION TAX CREDIT

June 6, 1989

Testimony of Sara Jean Lindholm, President of
City Lands Corp., Chicago, IL

Good afternoon. My name is Sara Jean Lindholm. I have developed real estate in a low and moderate income black community on the South Side Chicago for over ten years. I am here to testify to the important role that the rehabilitation tax credit has played in targeted developments in this neighborhood. I wish also to speak strongly in favor of H.R. 796, on the grounds that it will restore the usefulness of a powerful tool for the redevelopment of blighted inner city communities.

The company that I run, City Lands Corporation, is the for-profit, real estate development affiliate of the South Shore Bank of Chicago. The Bank and its affiliated companies have achieved national recognition for their central role in the successful redevelopment of South Shore. Over the past fifteen years, the South Shore Bank and its affiliates have invested over $147 million into this community of 80,000 residents, primarily for the rehab of the area's rental housing. In 1973, when the Bank began its lending activities, South Shore was shunned by lenders and investors alike. Most of the area's rental stock was being milked by absentee landlords and was clearly on the road to eventual abandonment. Today the real estate market in South Shore is once again active and healthy, and a strong cadre of community-based real estate operators has emerged, acquiring and rehabbing property with private, unsubsidized financing and considerable amounts of sweat equity, creating jobs and wealth locally while producing decent, affordable housing for community residents. Other lenders, who had withdrawn from the area in the 60's and 70's, have returned, creating healthy competition for the bank.

This miracle would not have occurred, however, without the strategic implementation of large-scale subsidized rehab projects by the Bank's development affiliates. The Bank soon learned from experience that the mere availability of credit does not initiate significant private investment in a declining community. Highly visible, catalytic developments must be put in place in strategic locations to prime the pump. Over the past ten years, City Lands has developed five such multi-building rehabs, ranging in size from 63 to 446 units, choosing the largest, most deteriorated and difficult properties in densely built or highly visible areas. The ripple effect of development emanating from these projects is unmistakeable. In effect, the placement of 950 units of subsidized housing has catalyzed the private production of an additional 5000 units of quality, affordable housing.

The equity requirements for City Lands' projects has ranged from $800,000 to over $5 million. Both the low-income tax credit and the rehabilitation tax credit have been of critical importance in raising these amounts. In particular, the rehab tax credit has been useful where our objective has been to create a mixed-income development, in which 30-40% of the units are rented to low income tenants and the balance are made available at affordable rents to moderate income individuals and families. I will briefly describe to you just one of these deals, the Jeffery Highlands, in which we used the rehab tax credit to produce 150 units of affordable housing, to solve an intractable development problem, and catalyze the redevelopment of 250 units of housing.

One half block south of the Bank's offices, right off the community's major commercial intersection, is the most densely

built-up block in South Shore. In the late 1920's, six large residential elevator buildings with a total of 450 units were constructed in a half-block area. Originally intended for occupancy by upwardly mobile white-collar professionals and elderly, these elegantly appointed buildings were built in a plethora of architectural styles, with small studios and one bedroom apartments and absolutely no open space. Because of the smallness of the units, these buildings declined very rapidly after racial transition, and the density of the area and the extent of blight made the buildings resistant to redevelopment. By early 1980, the largest property was abandoned and severely vandalized; vacancy rates in the other properties hovered between 20 and 35%; drugs and prostitution were prevalent and tenancy was highly transient.

Because the unit and building configurations were totally unsuited to low income family occupancy, we decided to attempt to redevelop the area by raising equity through the rehab tax credit. City Lands successfully sponsored a National Register nomination for the entire half-block area, called the Jeffery-Cyril Historic District, and moved to redevelop as many buildings as possible at one time as a mixed income development.

The project, which ultimately comprised three buildings and 150 units, took four years from conception to completion. The project required a complicated layering of financing and equity. Since the amount of the first mortgage required was far beyond the legal lending limit of the South Shore Bank, we arranged for tax-exempt bond financing through the City of Chicago, with FHA 221d(4) mortgage insurance. Because the market rents in South Shore are still modest at best, the first mortgage supported only 33% of development cost. The balance was funded with soft loans under the HODAG Housing Development Grant and Illinois Development Action Grant programs, and by an equity requirement of over $1 million.

Two years into the deal, the uncertainties created by Congressional deliberations on Tax Reform caused our original development partners to walk away from the project. We proceeded to take it to closing alone in June of 1987, using our own funds. In doing so, we placed the whole company at risk, because failure to syndicate the equity would have permanently paralyzed our capacity to do further development.

Over the next nine harrowing months, the awful significance of the passive loss restrictions was brought home to us. The Jeffery Highlands proved to be fairly unattractive to national equity pools. It was a market rate project in a low and moderate income minority area---not a standard rent-subsidized Section 8 development. In addition, the properties immediately adjacent were not yet rehabbed---and one of them was abandoned. To an outsider, this project appeared fraught with risk. Before the Tax Reform Act of 1986, we had been able to overcome problems of this nature by syndicating equity locally, without brokers, to individuals who were familiar with us and with our track record. For example, in 1985 we had raised over $900,000 from 20 individuals in the Chicago area for a similar historic, mixed-income development of 127 rental units. Because of the passive loss restrictions, this avenue was now closed to us.

Our only alternative was to find corporate investors, but we found this market to be pretty thin. A Boston-based syndicator agreed to attempt a private offering targetted to corporations, but after three months there was not a single taker. Finally, we were able to induce the Chicago Equity Fund, a locally-based investment partnership of socially responsible major corporations, to alter some of their standard investment criteria and purchase an 80% interest in the development. The closing on the syndication took place on March 31st, 1988, twenty-four hours before the first units were scheduled to be placed in service.

Fortunately, the project has been an outstanding success, both in terms of rent-up and development impact. A sophisticated marketing effort emphasized the historic nature of the buildings and the quality of the rehab, attracting a strong, mixed low- and moderate- income tenancy. As soon as the Highlands project was announced, redevelopment of the other three adjacent properties was undertaken by two other developers. Two hundred units have been rehabbed as a Section 8 project for the elderly. The remaining 49 are being redeveloped as a mixed income housing cooperative by our not-for profit affiliate, The Neighborhood Institute. By December of this year, the Jeffery-Cyril area will have been transformed from a very dangerous, blighted eyesore to a development anchor and a source of pride for the whole community.

We intend that this process be replicated again and again, not only in South Shore but in many, many other urban neighborhoods. The South Shore Bank and its affiliates have recently expanded their development operations into another community, this time on Chicago's West Side. This large minority community, called Austin, is even farther along in the disinvestment cycle than South Shore was fifteen years ago. Our strategic plan calls for City Lands to develop an average of 200 units a year there for the next three years, to help prime a long unused pump. However, the national equity markets will surely reject any but the most risk-free deals in this deteriorated neighborhood. We will not be successful unless both the rehab tax credit and the low income tax are preserved and their usefulness liberated by amending the passive loss restrictions.

I appeal to you to act favorably on H.R. 796, to enable us---and others---to continue to use the rehab and low-income tax credits flexibly and powerfully in neighborhoods which need them most. Thank you.

Mrs. KENNELLY. Thank you very much.
Mr. Gilbert.

STATEMENT OF WILLIAM E. GILBERT, PRESIDENT, GREAT INNS OF AMERICA, INC., ANNAPOLIS, MD

Mr. GILBERT. Thank you, Madam Chairman. My name is William Gilbert. I am president of Great Inns of America, with offices in Annapolis, MD. Great Inns provides various services for a group of approximately 95 historic hotels and inns located in the United States, Canada, Bahamas, and Puerto Rico; and is also a developer and operator of historic hotels and inns in the 40 to 80-room range, which means a cost of $4 million to $8 million.

In January 1986, a partnership of which Great Inns is a partner, purchased from the historic Richmond Foundation, a group of seven vintage 1860 townhouses and adjacent outbuildings for rehabilitation as a full-service inn and restaurant.

Design work and assembling of a financing package moved ahead. By August 1986, we were ready to begin work in anticipation of imminent equity financing, with the construction loan already agreed to by a local bank.

With the passage of the 1986 Tax Act, the project became marginally feasible. When the anticipated $800,000 tax credit attached to the project was no longer usable by individual investors because of the passive activity rule, this had the effect of increasing the cost of the project by about 15 percent.

In July 1987 still without equity financing, we elected to move ahead with the limited resources of the two development partners. After several near stops in construction, the project was finally financed without use of the tax credit in March 1988 and opened in November 1988—a year late—with loss instead of profit to the partners.

Other projects with which we have been involved have a similar history.

In late 1985, at the request of the owners of the historic Roycroft Inn, which Mr. Walter mentioned, which is in East Aurora, NY, we participated in the planning and design of a total redo of the inn and associated buildings.

In 1986, then-Congressman Jack Kemp sponsored the designation of the Roycroft collection of buildings as a National Historic Landmark. However, with the passage of the Tax Act of 1986, investor interest in the project disappeared, and the property eventually closed. It is now owned by the Landmark Society of Western New York, which has diligently attempted to interest developers in the project; but it still sits empty and deteriorating.

The other project which to date we have failed to finance is the old City Hall Opera House in Frederick, MD.

In September 1985 we participated in design competition to convert this historic building to a full-service inn. Design went ahead, and the approval process was going through; but it was impossible to raise the equity after the passage of the 1986 Tax Act.

We spent 8 to 10 months working with various sources, trying to raise equity for the project, and eventually had to give up the

project. As of this date, no development actions occurred in that beautiful building on Market Street in Frederick.

Inasmuch as the rehab of old buildings often costs more than totally new construction and, more important to investors, contains more uncertainties, and those uncertainties are sometimes environmental problems as well as structural problems, risk-taking investors simply must have an incentive which is not now present.

There is much preservation work to be done out there, and the interest is there. A beautifully restored historic inn is so much more pleasant than the plastic replications of the lodging chains. We want to get on with the work.

Thank you, Madam.

[The statement of William E. Gilbert follows:]

Statement by William E. Gilbert, President, Great Inns of America, Inc., before the Subcommittee on Select Revenue Measures U. S. House of Representatives

My name is William Gilbert. I am President of Great Inns of America, with offices at 2666 Riva Road, Annapolis, Maryland. (301-266-3800).

Great Inns provides various services for a group of approximately 95 historic hotels and country inns located in the U. S., Canada, Bahamas and Puerto Rico, and is also a developer and operator of historic hotels and inns.

In January 1986, a partnership, of which Great Inns is a partner, purchased from the Historic Richmond Foundation, a group of seven vintage 1860 townhouses and adjacent outbuildings for rehabilitation as a full service inn and restaurant.

Design work and assembling of a financing package moved ahead, and by August of 1986 we were ready to begin work in anticipation of imminent equity financing, with a construction loan already agreed to by a local bank.

With the passage of the 1986 tax act, the project became marginally feasible when the anticipated $800,000 tax credit was no longer usable by individual investors. This had the effect of increasing the cost of the project by about 15%.

In July 1987, still without equity financing, we elected to move ahead with the limited resources of the two development partners. After several near stops in construction, the project was finally financed in March 1988, and opened in November 1988, a year late, with loss instead of profit to the partners.

Other projects with which we have been involved have a similar history.

In late 1985, at the request of the owners of the historic Roycroft Inn, East Aurora, New York, we participated in the planning and design of a total re-do of the Inn and associated buildings.

In 1986, then Congressman Jack Kemp sponsored the designation of the Roycroft collection of buildings as a National Historic Landmark. However, with the passage of the tax act of 1986, investor interest in the project disappeared, and the property eventually closed. It is now owned by the Landmarks Society of Western New York which has diligently attempted to interest developers in the project, but it still sits empty.

The other project which to date we have failed to finance, is the old City Hall/Opera House in Frederick, Maryland.

In September 1985 we came in second in a design competition to convert this historic building to a full-service inn. The winning developer proceeded with design and the approval process, but was unable to raise equity after the passage of the 1986 tax act. In February 1987 the City of Frederick invited us to joint venture with the winning developer, after which we spent the next eight months negotiating with the developer, and then took over the project by ourselves. From October 1987 until August 1988 we met with private investors, investment groups, and with syndicators, without success, at which time our option expired. As of this date, no development action has occurred.

Inasmuch as rehab of old buildings often costs more than totally new construction, and more important to investors, contains more uncertainties (e.g., environmental problems such as asbestos) than new construction, risk-taking investors simply must have an incentive which is not now present. There is much preservation work to be done, and the interest is there. A beautifully restored historic inn is so much more pleasant than the plastic replications of the lodging chains.

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Mrs. KENNELLY. Thank you, sir, very much.
Mr. Simmons.

STATEMENT OF MARK J. SIMMONS, PRESIDENT, VULCAN DEVELOPMENT AND MANAGEMENT CORP., ALBANY, NY

Mr. SIMMONS. Thank you, Madam Chairman. For the record, my name is Mark Simmons. I am president of Vulcan Development Management Corp., which is a real estate development company located in Albany, NY.

My testimony, I believe, that I submitted is on the record. I would like to briefly summarize it, and then hit a few points.

Mrs. KENNELLY. And your entire testimony will be placed in the record.

Mr. SIMMONS. Thank you, Madam Chairman. I would like to discuss today a project that we undertook in Albany, called Historic Arbor Hill, which was what we call a major impact project in a deteriorated neighborhood in the center district of Albany.

It involved the historic rehab of 82 vacant and derelict buildings that we put together—that were taken in foreclosure—and we put the project together by negotiating the purchase of the buildings from the local authorities.

The impact of this project was instrumental in turning this neighborhood around. Similar to Ms. Lindholm's project in Chicago, I think the Historic Arbor Hill project made a major statement in the city of Albany in turning around a primarily minority community, to give it some hope and a future today.

We created over 233 units of residential housing for low and moderate-income individuals. In addition, 15 storefronts were renovated, which provide small areas for minority-owned firms to operate in the community.

Besides our project, over 40 other buildings were renovated after we started it. They were waiting on the sidelines to see if we would succeed; and we did. And we felt, obviously with the risk involved, this was a major undertaking.

I guess the key issues I would like to hit on are: Would this project happen today, under the Tax Act of 1986? And the answer is no. It could not happen. The whole key to our success with the project was raising $3.7 million in private equity financing.

Fortunately, Fred Copeman and Boston Bay Capital were available to raise it for us back in 1985. Without the private equity investment, this project could not have happened. All the financing was subsidized financing. It was tax-exempt bonds, and urban-development action grant, and private equity money.

The whole reason we were able to raise the private equity money was the use of the historic tax credits. We just made it by the end of 1986. I can share some of the concerns and experiences that the developers who have spoken today have went through in 1986 and early 1987. We were sweating to make it, to get all the buildings placed in service, so we would fall under—or before—the Act went into place in 1987.

There was a comment made earlier, I believe, by Congressman Andrews, concerning public benefit projects that the Treasury feels should only be allowed under historic tax credit proposals.

Is Historic Arbor Hill a public benefit project? We provided low and moderate-income housing. We turned around a neighborhood; but it is not open to the general public. If that were enacted, again, this project could not happen. So I think the scope should be certainly thought of wider than just public benefit projects.

The other point, I think is that economic reality is the true test of real estate development projects. We have been involved in over 100 historic rehab projects in the Albany, NY area. None of them, on today's standards, meet economic reality tests. They are driven totally by the tax credit incentives and the ability to raise a private equity financing.

The other issue that has come up just recently in Albany, and Albany is a city of 100,000, we ranked second in 1986 in tax ax projects in the country, which I think is quite an accomplishment for a small city.

Today, the city administrators are considering demolishing historic buildings in the city because they have become so deteriorated. This was unheard of or unthought of several years ago. The whole reason is speculators bought these buildings in the early 1980's, and they sat fallow once the tax laws changed.

Again, unless we look to some change in the passive loss rules, none of these buildings can be done. The cost to do these buildings is substantially more than new construction. The city administrators know that. The developers know it, and the only way to make it work is with the historic tax credit, to raise the private equity to reduce the cost of the project overall.

I thank you for this opportunity to speak before you today. Obviously, I am in support of the passage of the Committee Revitalization Tax Act of 1989.

Thank you.

[The statement of Mr. Simmons follows:]

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TESTIMONY OF MARK J. SIMMONS
PRESIDENT OF VULCAN DEVELOPMENT AND MANAGEMENT CORPORATION

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
HOUSE OF REPRESENTATIVES

JUNE 6, 1989

Chairman Rangel and members of the subcommittee:

I am Mark J. Simmons, President of Vulcan Development and Management Corporation, a real estate development company based in Albany, New York. I am pleased to testify on behalf of the Community Revitalization Tax Act - HR 796 - and its critical importance to future historic rehabilitation projects throughout our country.

I appear before you today to discuss the positive impact of the rehabilitation tax credit and how a public-private partnership project in Albany, New York utilizing these tax credits served as the catalyst to the revitalization of an entire urban residential neighborhood.

This project, called Historic Arbor Hill, involved the historic rehabilitation of 82 vacant and derelict buildings in the Arbor Hill Neighborhood of Albany, New York. Arbor Hill is predominantly a minority residential community that had experienced the typical American urban riches to rags development cycle. Once a moderate-income ethnic merchant neighborhood, Arbor Hill had deteriorated into a sparsely populated, crime-infested "war zone" just north of Albany's Central Business District. While other Downtown Albany neighborhoods were experiencing a rebirth through the rehabilitation tax credit provisions of the Economic Recovery Tax Act of 1981 (ERTA), Arbor Hill was experiencing little or no new investment due to its perceived negative image. My real estate development firm, Vulcan Development and Management Corporation (VDMC), sought to change all this when we assembled 82 tax-foreclosed properties together as a project in 1984. Through creative financing, such as tax-exempt bonds and HUD Urban Development Action Grant funds, we were able to actually convince people that the project was possible. But one extremely important financial component was missing, equity syndication funds from private investors. Without the private investment money, the lenders would not release their respective funds to commence the construction of the project. Finally in

November 1985, we received commitments for $3.7 million from private individual investors who were assembled by our project syndicator, Boston Bay Capital, Inc. All these private investment dollars were invested in our Historic Arbor Hill project due to the availability of the rehabilitation tax credit to the investors. Without the rehabilitation tax credit, there would have been no Historic Arbor Hill Project. To prove this point, I would like to explain the basic facts of the real estate syndication investment.

The actual project investment return to the private equity investors on a cash-on-cash basis was forecasted to be less than 3%. Needless to say, the investment marketplace demands a higher return than 3%. With the inclusion of the rehabilitation tax credit, the investment return approached 15% which, at the time of the equity syndication placement, was necessary for a high-risk project such as Historic Arbor Hill. Virtually all the project financing, including the $3.7 million private investor equity, went into bricks and mortar in the project.

The impact of this project has been tremendous. The $13 million Historic Arbor Hill project created 233 new residential apartment units for low and moderate income individuals and families. Fifteeen new retail storefronts were also renovated. Other private investors, who were waiting on the sidelines, followed our lead and rehabilitated other historic buildings in Arbor Hill. Today, the neighborhood boasts renewed vigor and spirit. Minority-owned small businesses have established operations in the neighborhood. Over 400 new rental and owner-occupied housing units have been newly constructed or renovated in Arbor Hill, with more new construction units planned over the next few years.

Arbor Hill now has a future due to the private investment generated by the availability of the rehabilitation tax credits. The real question at hand is whether our Historic Arbor Hill project could happen today. The answer is a resounding no. Private equity investment dollars have all but disappeared for high-risk projects such as Historic Arbor Hill. My firm has completely altered our real estate development strategy from doing $15 - $20 million of annual historic rehabilitation projects up to 1986, to almost all new construction work today. We cannot even consider a high-impact project such as Historic Arbor Hill due to the financing constraints imposed on the equity marketplace by the passive loss provisions of the Tax Reform Act of 1986. Private equity investment from individuals is virtually non-existent in historic rehabilitation projects today. Other equity sources, such as corporate investors, are equally inaccessible due to the Tax Reform Act of 1986.

Corporations are limited as equity investors due to two major factors. One, corporations have little previous real estate development experience and are, therefore, very cautious concerning their equity investments. And second, the corporate Alternative Minimum Tax provisions of the Tax Reform Act of 1986 limit the actual investment return of the rehabilitation tax credit in comparison to other equity investments, such as stocks or bonds.

In summary, the enactment of the Tax Reform Act of 1986 removed the primary incentive for private investment in historic rehabilitation projects, namely the rehabilitation tax credit. The proposed Community Revitalization Tax Act of 1989 restores many of these investment provisions and would act to renew the interest by private real estate developers and investors in historic rehabilitation projects throughout the country. It is my sincere hope that the Subcommittee on Select Revenue Measures will clearly understand the importance of this proposed legislation and recommend its enactment to the House of Representatives.

Thank you for the opportunity to present my oral testimony.

Mrs. KENNELLY. Thank you, Mr. Simmons.
Mr. Azola.

STATEMENT OF MARTIN P. AZOLA, PAST CHAIRMAN, NATIONAL REMODELORS COUNCIL, AND PRESIDENT, M.P. AZOLA, INC., BROOKLANDVILLE, MD, ON BEHALF OF NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. AZOLA. Thank you, Madam Chairman. After this long day of testimony, I find the rare privilege of following up here.

I am the fellow that you have heard so much about today, the small developer.

I am honored to be here representing the National Association of Home Builders' 157,000 members who are in favor of H.R. 796.

I would like to leave this prepared statement for the record and tell you my personal story.

Mrs. KENNELLY. Absolutely, your entire testimony will go on the record, and then you can use your own words, of course.

Mr. AZOLA. Thank you.

I would like to tell my personal story from Baltimore because I agree with all of the testimony I have heard today in favor of the bill. I am a practitioner. I am the guy out there who has risked his house, his home, his car, and every bit of his personal assets.

I run a business in one of America's hottest markets, the Baltimore/Washington corridor. I may close my business soon.

Ten years ago, I did my first tax credit project under the Revenue Act of 1978, and that was back in the very early days.

I built a business in Baltimore with five employees in the heyday, in the 1985–86 timeframe, when our niche in the market was hot. My payroll swelled to over 150 people.

I sit here today with five employees.

Congress was right, in my opinion as a practitioner, in its conscious decision to use investment tax credit incentives to promote the redevelopment of decaying urban areas.

I want to tell you that it works. Developers are profit-driven not because they are greedy but because the industry is fraught with an incredible amount of risks, not to mention governmental restrictions, environmental controls, land-use restrictions, changing interest rates, et cetera.

I had, in years gone by, an available pool of investors right in my hometown. I did what you heard about earlier, the small placements.

I am sure Congress felt comfortable in enacting the provisions of the 1986 Tax Reform Act, which closed some loopholes, while preserving what it thought was a workable rehabilitation tax credit provision.

But, I am here to tell you, having lived through with the good times and the bad, that it has not worked as planned. I want to reinforce what I think is your perspective that the restrictive application of the passive activity loss limits on the rehabilitation tax credits is the primary cause for my loss of investors. My market and my business has absolutely dried up in one of the Nation's hottest real estate markets.

The 1986 Tax Reform Act has very definitely affected small builders and developers. We do not have the resources for public syndications. It has most definitely affected our urban areas. Baltimore is a case in point. It is a vibrant city, yes, but not the vibrant city it was 2 years ago with respect to historic preservation.

In conclusion, I would like to reinforce all of the positive things that have been said about what we perceive that H.R. 796 will do. Now, it may not address all our problems. It will not address all the problems of the Nation's homebuilders, but by reinvigorating the rehabilitation tax credit, it will provide a most welcome first step in addressing these problems.

I want to thank you for this opportunity to testify and hope that you will ask me some questions.

[The statement of Mr. Azola follows:]

STATEMENT

of the

NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

of the

U.S. HOUSE OF REPRESENTATIVES

on

REHABILITATION TAX CREDIT

JUNE 6, 1989

Mr. Chairman and Members of the Subcommittee, my name is Martin P. Azola. I have been a builder in the State of Maryland since 1973. I am a member of the National Association of Home Builders (NAHB) and, recently, was the Chairman of its National Remodelors Council.

During my career as a builder, I have been involved in a wide range of activities, including the construction of commercial warehouses, renovation of office buildings and construction of single-family and multifamily homes. While working at J.R. Azola and Associates, I developed an interest in historic rehabilitation. This interest, which was kindled by job exposure to renovation and restoration projects, eventually evolved into M.P. Azola, Inc., of which I am currently the President.

Mr. Chairman, it is an honor for me to appear here today upon behalf of NAHB's 157,000 members to testify in favor of H.R.796 (the "Community Revitalization Tax Act of 1989"). It is with pleasure that I note over one-quarter of the Members of the House of Representatives, as well as over a third of the Members of the Ways and Means Committee have signed on as co-sponsors of this important legislation.

H.R.796 would cure a major defect in the law by easing the passive activity loss restrictions, as they apply both to the rehabilitation tax credit and the low-income housing tax credit. Since NAHB testified before this Subcommittee on May 23, 1989, on the low-income housing tax credit, our remarks today will concentrate primarily upon the rehabilitation tax credit.

Before turning to a discussion of the improvements that must be made to the rehabilitation tax credit, it would be worthwhile to recall the devastating impact that the Tax Reform Act of 1986 had on multifamily housing in general

THE TAX REFORM ACT OF 1986

The Economic Recovery Tax Act of 1981 stimulated the highest level of rental housing production in a decade. This increased the availability of rental housing throughout the country. Since that time, however, the tax incentives that were designed to encourage the production of decent, affordable rental housing have been cut back sharply or eliminated.

The Tax Reform Act of 1986 substantially reduced the attraction of investment in multifamily housing (as well as commercial buildings) by, among other things:

- Substantially restricting the deduction of losses from "passive" activities;
- Limiting deductions for investment interest;
- Repealing rapid amortization of low-income housing rehabilitation expenses;
- Substantially lengthening allowable depreciation lives (27-1/2 years/straight-line for residential rental property and 31-1/2 years for commercial buildings);
- Substantially restricting the issuance of multifamily industrial development bonds;
- Substantially strengthening the minimum tax provisions; and
- Repealing the capital gains tax preference.

The rehabilitation tax credit was one of the few tax incentives for real estate to survive tax reform. However, it was crippled severely by the passive activity loss restrictions.

REHABILITATION TAX CREDIT

The investment tax credit was first enacted in 1962. However, it was not until 1978 that buildings and their structural components became eligible for the credit.

When the investment tax credit was first enacted, the Congress was primarily concerned about the substantially greater average age and lower efficiency of machinery and equipment in domestic manufacturing facilities in comparison with the facilities of major foreign producers of the same products. When Congress enacted the rehabilitation tax credit, as part of the Revenue Act of 1978, it had a similar concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. In 1978, the Congress believed that it was appropriate to extend the initial policy objective of the investment tax credit to enable business to rehabilitate and modernize existing structures. It was felt that this change in the investment credit would promote greater stability of areas that had been deteriorating.

The original rehabilitation tax credit provision merely extended the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those that were used for residential purposes. Thus, eligible buildings included factories, warehouses, office buildings, hotels and retail and wholesale stores. In order to qualify for the credit, the investment expenses had to be incurred in connection with a building that had been in use for a period of at least 20 years prior to the rehabilitation.

The Economic Recovery Tax Act of 1981 made significant improvements to the rehabilitation tax credit. It replaced the regular 10 percent investment credit with a three-tier credit for qualified rehabilitation expenditures. The credit was 15 percent for non-residential buildings at least 30 years old, 20 percent for non-residential buildings at least 40 years old, and 25 percent for certified historic structures.

Under the 1981 Tax Act, the 15-percent and 20-percent credits were limited to non-residential buildings. However, the 25 percent credit that was available for rehabilitation of certified historic structures applied both to non-residential and residential depreciable buildings.

Major changes again were made to the rehabilitation tax credit by the Tax Reform Act of 1986. In 1986, the Congress concluded that the incentives that had been granted to rehabilitation in 1981 remained justified. It was felt that these incentives were needed because, among other things, market forces might otherwise channel investments away from rehabilitation projects because of the costs associated with the rehabilitation of historic and older buildings.

While the Tax Reform Act of 1986 retained the rehabilitation tax credit, it significantly limited its attractiveness. The former three-tier credit was changed to a two-tier credit. Thus, the credit percentage now is 20 percent for rehabilitation of certified historic structures and 10 percent for rehabilitation of buildings originally placed in service before 1936. However, more significant than these changes is the interaction of the passive activity loss restrictions with the credit.

In general, the passive activity loss restrictions applicable to individuals limit the availability of tax credits attributable to investment in passive activities to tax liability resulting from passive activity income. Individuals whose adjusted gross income is $200,000 or less are entitled to a deduction-equivalent of $25,000, thus, producing a maximum credit, unrestricted by the passive loss limits, of $7,000. This special allowance, however, phases-out for incomes between $200,000 to $250,000. (Regular corporations, of course, may take unlimited credits from eligible rehabilitation activities, subject only to the general limitation on business tax credits.)

In order to attract individual investors to rehabilitation activities, more must be provided in the way of tax incentives. Ideally, the rehabilitation tax credit should be exempt from the passive activity loss restrictions. However, there are several improvements that can be made short of an outright exemption from the passive loss limits. For example, the passive loss limits could be lifted for purposes of the regular tax but a portion (e.g., 50 percent) be included in the minimum tax base. Furthermore, the individual adjusted gross income limit for maximum use of the credit could be lifted.

Allowing the maximum credit to be utilized only by individuals whose adjusted gross income is $200,000 or less restricts the flow of money into qualified rehabilitation activities. It also complicates the structure of rehabilitation projects, because relatively large numbers of individual investors must be found in order to attract sufficient dollars to the investment, and high syndication fees may be required to put a sufficient number of investors together. So long as there are means of assuring that high-income individuals cannot "zero out" their tax liability through investments in qualified rehabilitation activities, there does not seem to be any point in limiting the maximum utilization of the credit to individuals below a specified income level.

The pamphlet prepared by the staff of the Joint Committee on Taxation in connection with this hearing ("Present Law and Issues Relating to the Low-Income Housing and Rehabilitation Tax Credits," JCS-12-89) indicates that both the numbers and dollar value of rehabilitation projects utilizing rehabilitation tax credits has declined in recent years. The number of rehabilitation projects approved by the Department of Interior was 3,214 in FY'84. Since that time, the number of approved projects has declined steadily to 1,092 in FY'88. Likewise, the dollars of private investment committed to rehabilitation projects fell from a peak of $2.4 billion in FY'85 to approximately $.9 billion in FY'88.

While it may be true that the passive activity loss restrictions upon the utilization of the rehabilitation tax credit are not the only reason for this significant decline in activity, they surely are a major, contributing factor.

THE COMMUNITY REVITALIZATION TAX ACT OF 1989

Mr. Chairman, NAHB strongly favors immediate enactment of the Community Revitalization Tax Act of 1989 (H.R.796).

As you know, H.R.796 would exempt both the rehabilitation tax credit and the low-income housing tax credit from the passive activity loss restrictions imposed by the Tax Reform Act of 1986. Losses from those activities, however, would remain subject to these restrictions.

While we would prefer that you examine more thoroughly the impact of the passive activity loss restrictions, in general, upon rental real estate activities, we believe that immediate attention is needed to revitalize both the rehabilitation tax credit and the low-income housing tax credit. Under H.R.796, taxpayers would be permitted to use $20,000 of tax credits per year plus an amount equal to 20 percent of additional tax liability. NAHB believes that by enacting H.R.796, the Congress would increase the pool of investors eligible to use the rehabilitation and low-income housing tax credits, reduce transaction costs by expanding the number of financing mechanisms, and simplify the use of these credits by applying uniform eligibility rules to all taxpayers.

CONCLUSION

Mr. Chairman, over the past several decades our nation's cities have suffered. Moreover, we are currently in the midst of an increasing housing affordability crisis.

In its attempt to reduce tax rates for all Americans and to "level the playing field" for American business, the Tax Reform Act of 1986 dealt a severe blow to this nation's housing and real estate industry. The time has come for you to begin to examine seriously the role of the Tax Code in revitalizing our nation's cities and assuring an adequate supply of affordable housing. Where necessary, the 1986 Tax Act must be fine-tuned in order to reverse the decline in our nation's cities and alleviate the affordable housing crisis.

While H.R.796 may not address all of the problems that our nation's homebuilders would like to have addressed, by reinvigorating both the rehabilitation tax credit and the low-income housing tax credit, it would provide a most welcome first step in addressing these problems.

Mr. Chairman, I thank you for this opportunity to testify and I look forward to working with you to achieve enactment of this important legislation. I would be glad to answer any questions you may have about my statement.

Mrs. KENNELLY. Thank you, Mr. Azola. The first question I would like to ask is to the entire panel.

As you have heard, some of the witnesses today have testified that the 1986 Act has resulted in a decrease in the number of individuals who are willing to invest in a rehab project.

Do you feel that corporations are a potential source to provide significant financing? We are told this in various conversations. We read it in some publications. If they are, why are they, but if they are not, why are they not?

Mr. AZOLA. I have had no success in attracting corporate interest for reasons that the Bay Capital fellow mentioned. Their interest seems to be primarily in safer, nonrisky investments.

Mrs. KENNELLY. You have attempted?

Mr. AZOLA. Yes, I have, and have had no success.

Mrs. KENNELLY. Ms. Lindholm?

Ms. LINDHOLM. Jeffrey was on the market to corporations for 3 months in a private placement offering. Not a single taker, and we had to take it to a socially responsive consortium that had been put together to invest in low-income housing, and convince them that Jeffrey, even though it was not a 100-percent low-income, and that we were a for-profit developer, was worthy of their investment.

But, the universal world of corporations, we could not get in the front door because it is a totally new thing to them, and it looks to them like a scam.

Mrs. KENNELLY. It looks to them like a what?

Ms. LINDHOLM. A scam. I mean to a corporate treasurer who is running a company that makes widgets, this thing where you look like you are making a big development fee on something which is really paying for your whole operation for 4 years, he does not understand the structure of the deal.

Mrs. KENNELLY. What you are saying is that those that say if individuals will not go in, the corporations will; that that is just not reality in the business world that you are dealing with.

Ms. LINDHOLM. It has not been our experience.

Mr. GILBERT. I would agree with that. We have done a lot of work trying to interest corporations, and we found that corporations who have excess cash do not want to put it in risky real estate unless they are already in some phase of real estate where they comfortable with it and understand it. But, in general, they do not want to invest in real estate.

Mr. SIMMONS. The other issue on the corporation side is if they are going to invest in real estate, they are looking at an economic deal, and I think 99 out of 100 historic rehab deals are not true economic deals. They cannot show a reasonable cash on cash return. They are tax credit-driven.

We did a $6 million deal in Troy, NY, just adjacent to Albany. We tried for 6 months to attract corporations. We were unable to. We went to Boston Bay Capital to place it in their public fund, and it was too small. So, we are doing it on our own account, and hopefully over the next 15 years, we will use the tax credit up.

But we were so far along that we had to go ahead and do it.

Mrs. KENNELLY. Thank you. I have another question that I want to ask and see if we can get it clearly answered on the record.

The report done by the National Park Service references some support for the theory that intermediate-sized projects between $500,000 and $5 million are the ones most adversely impacted by the 1986 act's changes since the smaller projects can be financed with smaller equity requirements that can be met with a few investors while the larger projects can take advantage of public offering opportunities. It is the middle ones that are in deep trouble.

As Mr. Azola said to me, that maybe is not true.

Mr. AZOLA. No, I think the Park Service's report is very accurate. The range that you just mentioned is the range that I work in.

Mrs. KENNELLY. OK.

Mr. AZOLA. And there is a very simple reason. The smaller projects do require less capital. Very often resources that the developer, which may be husband and wife or an individual, has access to through their own resources.

The larger projects that need to be syndicated to $5 million and up, can still be done through those kinds of public offerings, if there are projects to do, of course.

Those in the middle are too small for larger lenders, for the institutional folks, the insurance companies. We deal with local banks.

Mrs. KENNELLY. Excuse me sir, I am just going to——

Mr. AZOLA. My point is that that middle-range is a local issue. Local lenders are conservative, and require perhaps 20 percent cash, take a $2 million example, $400,000 in capital. That puts you into a public offering.

I cannot do it. Nor can I go back to my three friends who would have, in 1986, given me the $400,000. So, I am in a catch-22 situation. I can raise some of it, but not all of it.

Mrs. KENNELLY. You cannot put it together?

Mr. AZOLA. No, ma'am.

Mrs. KENNELLY. Thank you. And I would like you all to know that the ranks have not been wide today. It is an unusual day in the Congress.

I want you to know that your excellent testimony will be seen by the rest of the subcommittee. This bill H.R. 796 has a great deal of interest. I think the testimony today shows that if Mr. Azola is going to stay in business, we need it, and if we are going to continue to revitalize and retain our history for our future generations to even see, we need it.

I think more importantly, our communities need it so they can remain communities as we knew them when we were growing up.

So, I really thank all of you, and I know in the audience there are some people that have given incredible amounts of time to the success of the credit and to seeing if we can do something here to make it work better. All of your testimony has been excellent, and I thank you very much.

[Whereupon, at 5:13 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

CITY OF COVINGTON
18 WEST PIKE • OLD TOWN PLAZA • COVINGTON, KENTUCKY 41011

June 1, 1989

The Honorable Dan Rostenkowski
211 Rayburn House Office Building
Washington, D.C. 20515-1308

RE: Community Revitalization Tax Act of 1989 (HB 796)

Dear Representative Rostenkowski:

Preservation Action has informed us that the House Ways and Means Committee will hear testimony on the Rehab Credit portion of the Community Revitalization Tax Act (H.R. 796) on June 6, 1989.

Enclosed is a copy of a Resolution from the Covington Board of Commissioners expressing their support of the Community Revitalization Tax Act.

Also enclosed are letters from the area developers and city officials to Kentucky Senators and Representatives expressing their support of CRTA, together with responses they have received.

We appreciate your continued interest in the rehabilitation tax credits.

Sincerely

Thomas B. Fiorini, Director
Economic Development Director

Leah Konicki
Preservation Specialist

ls

ENCLOSURES

[THE LETTERS THAT WERE ENCLOSED WITH THIS LETTER ARE BEING RETAINED IN THE COMMITTEE FILES.]

COMMISSIONERS' ORDER/RESOLUTION NO. O/R-181-89

AN ORDER/RESOLUTION RECOGNIZING THE IMPORTANCE OF THE REHABILITATION TAX CREDIT TO PRESERVATION ACTIVITY IN KENTUCKY AND SUPPORTING EFFORTS TO RETAIN AND IMPROVE THE EFFECTIVENESS OF THE TAX CREDIT.

* * *

WHEREAS, the Federal rehabilitation tax credit has played a critical role in promoting reinvestment in deteriorated historic structures throughout the Commonwealth of Kentucky; and

WHEREAS, the quality of the Commonwealth's historic buildings and the number of certified rehabilitations has caused the State to be recognized nationally as a center of respectful rehabilitation activity and responsible preservation planning; and

WHEREAS, Kentucky has been ranked 8th in the nation with over 700 project reflecting an investment of well over $315 million in the rehabilitation of historic structures; and

WHEREAS, the City of Covington has benefited from 119 historic rehabilitation projects representing an investment of over $22.5 million; and

WHEREAS, the 1986 federal tax reform legislation, though retaining the rehabilitation credit, imposed rules on its use that have severely limited its usefulness to many investors in historic projects; and

WHEREAS, this limitation has resulted in an approximately 70% reduction statewide in historic rehabilitation projects; and

WHEREAS, The Community Revitalization Tax Act of 1989 has been introduced in the United States Senate by Jack Danforth and Wendell Ford and in the House of Representatives by Barbara Kennelly and Romano Mazzoli to remedy the problem by removing some of the rules and limitations that have curtailed its use by

investors; and

WHEREAS, Communities across the Commonwealth have encouraged and supported public and private historic preservation projects, and are deeply concerned about the drastically reduced investment following 1986 tax reform.

NOW, THEREFORE,
BE IT RESOLVED BY THE BOARD OF COMMISSIONERS OF THE CITY OF COVINGTON, KENTON COUNTY, KENTUCKY:

Section 1

That the City of Covington recommends and endorses efforts to retain and improve the effectiveness of the rehabilitation tax credit and hereby urges the United States Congress to act favorably upon the Community Revitalization Tax Act of 1989.

Section 2

That this order/resolution shall take effect and be in full force when passed and recorded according to law.

Denny Bowman
MAYOR

ATTEST:

Carol Little
CITY CLERK

Passed: 5/9/89

STATEMENT OF CHARLES L. EPPRIGHT
FOR SUBMISSION TO THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

The undersigned represents four taxpayers in Austin, Texas, who have been adversely affected by the Treasury Department's retroactive adoption of Treas. Reg. §1.48-12(b)(15), which was first issued as a Proposed Treasury Regulation on June 28, 1985, and was finally adopted on October 7, 1988. The taxpayers are Mr. and Mrs. George S. Nalle, III, and Mr. and Mrs. Charles A. Betts, and this statement is being submitted on behalf of Mr. and Mrs. Nalle and Mr. and Mrs. Betts.

During the years 1983, 1984, 1985, and 1986, George S. Nalle, III, both individually and as a Joint Venturer in Heritage Square Joint Venture, purchased buildings older than 40 years, moved the buildings to Heritage Square, an historic office subdivision located off Bee Cave Road in Austin, Texas, and rehabilitated the buildings. The buildings rehabilitated by Mr. Nalle during the years in issue are known as the Kluge House, the Julia Harris House, the Bohls House, the Dimmitt House, the Anderson House, the Johnson House, the Mabry House, and the Commissioner's House. The Kluge House and the Julia Harris House were purchased by Heritage Square Joint Venture and moved to Heritage Square in 1982. All of the other rehabilitated buildings were purchased by Mr. Nalle individually and moved to Heritage Square in 1983 and 1984. In rehabilitating the buildings, Heritage Square Joint Venture and Mr. Nalle incurred qualified rehabilitation expenditures as follows:

	1983	1984	1985	1986
Kluge House	$ 70,390	$123,718	$ 18,241	
Bohls House	59,645	419,938	7,576	
Dimmitt House		149,896	183,521	
Anderson House		30,974	207,543	$152,051
Johnson House		85,163	198,898	143,922
Mabry House		28,192	185,174	134,596
Commissioner's House		83,348	192,484	40,781
Julia Harris House	178,004			
TOTAL	$308,039	$921,229	$993,437	$471,350

In 1983, Heritage Square Joint Venture conveyed the Julia Harris House to Mr. and Mrs. Betts, and elected to pass the rehabilitation tax credit through to Mr. and Mrs. Betts who claimed a rehabilitation tax credit of $35,601.00 on their 1983 Form 1040. Mr. and Mrs. Nalle claimed rehabilitation tax credits for qualified rehabilitation expenditures on the houses owned by them as follows:

	1983	1984	1985	1986
Kluge House	$ 14,078	$ 24,744	$ 3,648	
Bohls House		95,917	1,515	
Dimmitt House			66,683	
Anderson House			47,703	$ 30,410
Johnson House			56,812	28,784
Mabry House			42,673	26,919
Commissioner's House			55,166	8,156
TOTAL	$ 14,078	$120,661	$274,200	$ 94,269

Each of the buildings was more than 40 years old on the date the physical work on the rehabilitation began, each of the buildings was substantially rehabilitated, each of the buildings was placed in service before the beginning of the rehabilitation,

and at least 75 percent of the existing external walls of each building were retained in place as external walls in the rehabilitation process.

In June of 1985, four years following the enactment of Section 48(g) of the Internal Revenue Code, the Treasury Department published Proposed Treasury Regulation §1.48-12(b)(5) which provides:

> "(5) Location at which the rehabilitation occurs. A building, other than a certified historic structure (within the meaning of paragraph (d) of this section) is not a qualified rehabilitated building unless it has been located where it is being rehabilitated for the thirty-year period immediately preceding the date physical work on the rehabilitation began in the case of a 30-year building or the forty-year period immediately preceding the date physical work on the rehabilitation began in the case of a 40-year building. (See §1.46-1(q)(1) for the definition of '30-year building' and '40-year building.'"

Proposed Treasury Regulation §1.48-12 was not proposed until June 28, 1985, well after all of the buildings in question were purchased, moved to Heritage Square and rehabilitation commenced. On October 7, 1988, three (3) years following the publication of Proposed Treasury Regulation §1.48-12 and seven (7) years following the enactment of I.R.C. §48(g), the Treasury Department finally adopted Treas. Reg. §1.48-12, which adopted Proposed Treas. Reg. §1.48-12(b)(5) without change. This regulation purports to be applicable to all expenditures incurred after December 31, 1981 in connection with the rehabilitation of a qualified rehabilitated building. Treas. Reg. §1.48-12(a)(2).

As described previously, each of the buildings was moved to Heritage Square and rehabilitation commenced in 1982, 1983, and 1984. By the time that Proposed Treas. Reg. §1.48-12 was proposed, June 28, 1985, each of the buildings had been purchased, each of the buildings had been moved to Heritage Square, rehabilitation had commenced on each building, and a substantial portion of the rehabilitation expenditures had been incurred. At the time that the taxpayers incurred these expenditures, the taxpayers had no clue that the proposed regulations would seek to deny the rehabilitation credit for buildings which were relocated from their original location. Certainly, there was no such restriction in either the statute (§212 of the Economic Recovery Tax Act of 1981) nor in the legislative history pertinent to the adoption of that section. Likewise, the Commissioner had issued no revenue rulings or other published opinion, in which this view was expressed. The only guidance offered by the Internal Revenue Service was contained in the regulations interpreting the predecessors of the statutory provision in question, which regulations expressly sanctioned the relocation of the building and included the costs of moving the structure in amortizable basis.

Section 48(g) of the Internal Revenue Code was added by §212 of the Economic Recovery Tax Act of 1981. I.R.C. §48(g) amended former I.R.C. §48(g) which allowed a 10 percent investment tax credit for certain rehabilitation expenditures and replaced I.R.C. §191 which allowed rehabilitation expenditures of certified historic structures to be amortized over a 60 month period. Under §48(g), as amended in 1981, taxpayers are allowed an investment tax credit for qualified rehabilitation expenditures. The amount of the credit depends upon whether the building is a 30-year building, a 40-year building, or a certified historic structure. In the instant case, each of the buildings was more than 40 years old at the commencement of rehabilitation. Neither I.R.C. §48(g) or any other provision of §212 of the Economic Recovery Tax Act of

1981 prohibits the relocation of a certified historic structure, a 30-year building, or a 40-year building. Likewise, nothing in the committee reports to the Economic Recovery Tax Act of 1981 indicates an intention on the part of Congress to restrict the allowance of the credit to buildings which have not been relocated prior to rehabilitation.

At the time that the taxpayers acquired the buildings, moved them to Heritage Square, and commenced rehabilitation, the Commissioner had issued no regulations, proposed regulations, or rulings construing §48(g) as amended in 1981. The only guidance offered by the Commissioner came from Proposed Treas. Reg. §1.48-11 (which was finally adopted on June 27, 1985) and Treas. Reg. §1.191-2(e)(6). Proposed Treas. Reg. §1.48-11 construed the pre-1982 version of §48(g) and contained no restriction on relocation of the structure. Treas. Reg. §1.191-2(c)(6) construed §191, which allowed accelerated amortization of certain rehabilitation expenditures to certified historic structure. This regulation not only sanctioned the relocation of the structure, but provided that the costs attributable to the relocation are included in the basis for amortization if the relocation is approved by the Secretary of the Interior. Based upon these regulations and proposed regulations, as well as the express language of the statute and the legislative history, the taxpayers could reasonably conclude that relocation of the structures was permissible, and would not affect their entitlement to the rehabilitation credit.

In determining the validity of a Treasury Regulation, the first inquiry is whether the regulation in question is a legislative regulation or an interpretive regulation. A legislative regulation is given greater deference than an interpretive regulation. A legislative regulation is one promulgated pursuant to a specific grant of authority in the statute being construed. On the other hand, an interpretive regulation is one adopted under the general authority granted in I.R.C. §7805(a) "to prescribe all needful rules and regulations." See Miller v. United States, 88-1 U.S.T.C. ¶13,757 (C.D. Ill. 1988). Section 212 of the Economic Recovery Tax Act of 1981 does not contain a specific grant of authority to the Commissioner to promulgate regulations. Consequently, the proposed regulation in issue is an interpretive regulation proposed under the general grant of authority in I.R.C. §7805(a). In deciding the validity of an interpretive regulation, a court will consider (1) whether the regulation harmonizes with the statutory language; and (2) whether the regulation adds a requirement not found in the underlying statute. See Miller v. United States, supra. A regulation which contradicts the unambiguous language of the statute it purports to interpret cannot stand. Citizen's National Bank of Waco v. United States, 417 F.2d 675 (5th Cir. 1969); CWT Farms, Inc. v. Commissioner, 79 T.C. 1054, 1062 (1982), aff'd 755 F.2d 790 (11th Cir. 1985); Gresham v. Commissioner, 79 T.C. 322, 331 (1982), aff'd 752 F.2d 518 (10th Cir. 1985). Moreover, where the statute is unambiguous, and there is no valid reason for adding a requirement to those the statute already provides, the Commissioner may not usurp Congressional authority by adding such a requirement by regulation. CWT Farms, Inc. v. Commissioner, supra. Furthermore, a regulation will be held to be invalid if it is inconsistent with the statute's legislative history and purpose. United States v. Vogel Fertilizer Co., supra.

Here, the intent of Congress in adopting §212 of ERTA was to promote the rehabilitation and preservation of structures more than 30 years old and certified historic structures. The prohibition on relocation of 30 year buildings and 40 year buildings contained in Treas. Reg. §1.48-12(b)(5) is inconsistent with the intent of Congress in adopting §212 of ERTA. In addition, Treas. Reg. §1.48-12(b)(5) attempts to draw a distinction between 30 and 40 year buildings on the one hand (for which relocation is prohibited) and certified historic structures on the other hand (for which relocation is permitted). Neither the statute nor the legislative history contains any basis whatsoever for drawing this distinction between the two classes of

buildings. In summary, Treas. Reg. §1.48-12(b)(5) has added a requirement not contained in the statute or legislative history and has drawn a distinction not warranted by either the statute or legislative history. Accordingly, the regulation is invalid due to the Commissioner's usurpation of Congressional authority.

In the instant matter, each of the houses was scheduled for demolition, and would have been demolished had Mr. Nalle and Heritage Square Joint Venture not purchased the buildings, moved them to Heritage Square and rehabilitated the buildings. If Treas. Reg. §1.48-12(b)(5) is not modified or revoked, it will frustrate the Congressional intent to promote the rehabilitation and preservation of structures more than 30 years old, since there will be many instances where the owner of such a structure is either unable or unwilling to rehabilitate the structure in its existing location. Since this section of the Treasury Regulation has added a requirement not contained in the statute or legislative history and has drawn a distinction not warranted by either the statute or legislative history, I submit that Congress should amend §48(g) by adding subparagraph (g)(1)(E) as follows:

> "(E) COSTS OF RELOCATION. Costs attributable to relocation of a building (including a building other than a certified historic structure) are qualified rehabilitation expenditures."

Alternatively, I submit that Congress should limit the retroactive application of Treas. Reg. §1.48-12(b)(5) to rehabilitations that were commenced after the publication of the Proposed Treasury Regulations, on June 28, 1985. At the time that these taxpayers and others similarly situated purchased the structures, moved them to new locations, and rehabilitated the structures, they had no clue from either the statute, the legislative history, or prior rulings and regulations of the Internal Revenue Service, that the regulations would seek to deny the rehabilitation tax credit for buildings which were relocated from their original location. These taxpayers were reasonable in concluding that relocation of the structures was permissible and would not affect their entitlement to the rehabilitation tax credit, and Congress should therefore limit the applicability of Treas. Reg. §1.48-12(b)(5) to rehabilitations which were commenced subsequent to June 28, 1985.

Respectfully submitted,

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May 25, 1989

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Written Statement on Rehabilitation Tax Credit

Dear Mr. Leonard:

I am submitting this written statement on the rehabilitation tax credit in connection with the public hearing to be held by the House Ways and Means Subcommittee on Select Revenue Measures on June 6, 1989. I would like to bring to your attention a problem which I believe is worthy of a technical correction involving the rehabilitation tax credit.

Background

This problem was discovered during our firm's representation of a group who wished to raise funds to rehabilitate the Windsor Hotel in Americus, Georgia. The Windsor Hotel property is a landmark structure covering almost an entire city block in downtown Americus. It was built in 1892 and has been designated a Certified Historic Structure by the United States Department of the Interior. The Windsor Hotel has been closed since 1979 and the economic vitality of the City of Americus has suffered as a consequence.

The organizers proposed to rehabilitate the property for use as a hotel to serve local businesspersons and a growing number of tourists due to the proximity of former President Jimmy Carter's hometown of Plains, and Andersonville, location of a Confederate prisoner-of-war camp. A limited partnership was formed to accommodate the several hundred local citizens who wished to invest in the hotel project.

The organizers expected that the limited partners would receive the benefit of the rehabilitation tax credit and be eligible for the exception to the passive loss limitations for such credit. However, due to a definitional problem affecting hotels in particular, it appears that the limited partners would not be eligible for the exception to the passive loss limitations applicable to the rehabilitation tax credit.

Exception to Passive Loss Limitations
for Rehabilitation Tax Credits

Under Section 469 of the Internal Revenue Code, rehabilitation tax credits attributable to passive activities may be deducted only to the extent of regular tax on passive income. Although a hotel is not a passive activity, an investment as a limited partner in a partnership operating a hotel is a passive activity under Section 469(h)(2). Thus, limited partners of a partnership operating a hotel must satisfy the exception provided in Section 469(i) in order to avoid the passive loss limitations.

Section 469(i)(1) sets forth a general exception to the passive loss limitations for losses (or the deduction equivalent of credits) which are attributable to all rental real estate activities with respect to which the taxpayer actively participated. The aggregate amount to which this exception applies shall not exceed $25,000 in losses (or the deduction equivalent of credits) for any taxable year. Section 469(i)(2). Section 469(i)(6)(B) modifies the general exception in the case of rehabilitation tax credits so that the exception is applied without regard to the active participation requirement. Section 469(i)(3)(B) also modifies the exception in the case of rehabilitation tax credits so it is phased out for taxpayers with adjusted gross incomes in excess of $200,000.

Hotel is Not a Rental Real Estate Activity

While the active participation requirement of the passive loss exception does not apply in the case of a rehabilitation tax credit, the credit must still be attributable to a rental real estate activity under Section 469(i)(1). The term "rental activity" is defined generally in Section 469(j)(8) as "any activity where payments are principally for the use of tangible property". Both the Senate Finance Committee Report (page 742) to the Tax Reform Act of 1986 and the subsequently issued Regulation Section 1.469-1T(e)(3) indicate that the rental of hotel rooms or similar space used primarily for lodging for transients generally is not a rental activity. The theory behind excluding a hotel from the definition of rental activity is that a long-term rental activity is passive and should be subject to the passive loss limitations, but a hotel is really an active operating business requiring significant day-to-day management and should not be subject to the passive loss limitations.

The result is that individuals investing in passthrough entities that operate rehabilitated hotels will be limited in their use of the rehabilitation tax credit because a hotel is not a "rental real estate activity" for purposes of the exception to the passive loss limitations set forth in Section 469(i)(6)(B). The application of the passive loss limitations would severely limit the use of the rehabilitation tax credits by the local citizens of Americus who want to invest in the limited partnership.

Tax Policy

If the Windsor Hotel property were to be rented as offices or even long-term residential apartments, such uses would satisfy the definition of "rental real estate activity". The investing partners would receive the full benefit of the rehabilitation tax credit under the passive loss exception contained in Section 469(i). There is no valid tax policy for distinguishing hotels from other rental real estate activities for purposes of the rehabilitation tax credit. The Windsor Hotel property in Americus is a perfect example of a landmark historic structure, crucial to the local economy, which should receive the full benefit of the rehabilitation tax credit. The fact that the Windsor Hotel will be used as a hotel should not affect its eligibility for exclusion from the passive loss limitations.

I believe this problem was unintentionally created by defining "rental activity" so as to exclude a hotel from the passive loss limitations. Such a definition did not contemplate use of a passthrough entity to obtain financing for the rehabilitation of a hotel. The use of the passthrough entity causes the application of the passive loss limitations even though a hotel is otherwise excluded from the passive loss limitations. The same problem may also arise with passthrough entities investing in low income housing to be used primarily for transients.

Suggested Technical Correction

I suggest the following technical correction to Section 469(i)(6)(B)(suggested additions are underlined):

> "No participation <u>or rental real estate</u> requirements for low income housing or rehabilitation credit. Paragraphs (1) and (4)(A) shall be applied without regard to the active participation requirement <u>and the rental real estate requirement</u> in the case of -

(i) any credit determined under Section 42 for any taxable year, or

(ii) any rehabilitation investment credit (within the meaning of Section 48(o)).

I greatly appreciate your consideration of this proposal. If I can help in any way in presenting this proposal to the subcommittee, please do not hesitate to contact me.

Sincerely yours,

Scott C. Withrow

Scott C. Withrow

SCW/glb

cc: T. Kennerly Carroll, Esquire
James C. Gatewood, Esquire

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